Bulletin No. 1997–7
February 18, 1997

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Rev. Rul. 97–8, page 4.
LIFO; price indexes; department stores. The December 1996 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, December 31, 1996.

T.D. 8700, page 5.
Final regulations under section 475 of the Code provide guidance to enable taxpayers to comply with the mark-to-market requirements applicable to dealers in securities.

T.D. 8701, page 23.
Final regulations provide rules for making the deemed sale and deemed dividend elections under section 1291 of the Code.

T.D. 8707, page 17.
Final regulations under section 731 of the Code provide rules for partnership distributions of marketable securities and for determining when those distributions are taxable to the distributee partner.

REG–209040–88, page 34.
Proposed regulations under section 1295 permit certain shareholders to make a special election, in lieu of the election currently provided for under that section, for certain preferred shares of a passive foreign investment company (PFIC). A public hearing will be held on May 8, 1997.

REG–209817–96, page 41.
Proposed regulations under section 7701 of the Code relate to the treatment of certain multiple-party financing transactions in which one party realizes income from leases or similar agreements and another party claims deductions related to that income. A public hearing will be held on April 29, 1997.

REG–249819–96, page 50.
Proposed regulations under sections 354, 355, and 356 of the Code relate to exchanges of stock and securities in certain reorganizations. A public hearing will be held on March 25, 1997.

REG–252231–96, page 52.
Proposed regulations under section 368 of the Code provide that the continuity of shareholder interest requirement for corporate reorganizations is satisfied if the acquiring corporation furnishes consideration which represents a proprietary interest in the affairs of the acquiring corporation and such consideration represents a substantial part of the value of the stock or properties transferred. A public hearing will be held on May 7, 1997.

EXEMPT ORGANIZATIONS

Announcement 97–12, page 55.
A list is given of organizations now classified as private foundations.

ADMINISTRATIVE

T.D. 8698, page 29.
Final regulations under section 6231 of the Code provide guidance necessary for the designation or selection of a tax matters partner for partnerships, including limited liability companies classified as partnerships.

Finding Lists begin on page 59.
Announcement of Disbarments and Suspensions begins on page 57.

Mission of the Service

The purpose of the Internal Revenue Service is to collect the proper amount of tax revenue at the least cost; serve the public by continually improving the quality of our products and services; and perform in a manner warranting the highest degree of public confidence in our integrity, efficiency and fairness.

Statement of Principles of Internal Revenue Tax Administration

The function of the Internal Revenue Service is to administer the Internal Revenue Code. Tax policy for raising revenue is determined by Congress.

With this in mind, it is the duty of the Service to carry out that policy by correctly applying the laws enacted by Congress; to determine the reasonable meaning of various Code provisions in light of the Congressional purpose in enacting them; and to perform this work in a fair and impartial manner, with neither a government nor a taxpayer point of view.

At the heart of administration is interpretation of the Code. It is the responsibility of each person in the Service, charged with the duty of interpreting the law, to try to find the true meaning of the statutory provision and not to adopt a strained construction in the belief that he or she is ''protecting the revenue.'' The revenue is properly protected only when we ascertain and apply the true meaning of the statute.

The Service also has the responsibility of applying and administering the law in a reasonable, practical manner. Issues should only be raised by examining officers when they have merit, never arbitrarily or for trading purposes. At the same time, the examining officer should never hesitate to raise a meritorious issue. It is also important that care be exercised not to raise an issue or to ask a court to adopt a position inconsistent with an established Service position.

Administration should be both reasonable and vigorous. It should be conducted with as little delay as possible and with great courtesy and considerateness. It should never try to overreach, and should be reasonable within the bounds of law and sound administration. It should, however, be vigorous in requiring compliance with law and it should be relentless in its attack on unreal tax devices and fraud.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents of a permanent nature are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
With the exception of the Notice of Proposed Rulemaking and the disbarment and suspension list included in this part, none of these announcements are consolidated in the Cumulative Bulletins.

The first Bulletin for each month includes an index for the matters published during the preceding month. These monthly indexes are cumulated on a quarterly and semiannual basis, and are published in the first Bulletin of the succeeding quarterly and semi-annual period, respectively.

For sale by the Superintendent of Documents U.S. Government Printing Office, Washington, D.C. 20402.

Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 472.—Last-in, First-out Inventories

26 CFR 1.472–1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The December 1996 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, December 31, 1996.

Rev. Rul. 97–8

The following Department Store Inventory Price Indexes for December 1996 were issued by the Bureau of Labor Statistics on January 14, 1997. The indexes are accepted by the Internal Revenue Service, under § 1.472–1(k) of the Income Tax Regulations and Rev. Proc. 86–46, 1986–2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, December 31, 1996.

The Department Store Inventory Price Indexes are prepared on a national basis and include (a) 23 major groups of departments, (b) three special combinations of the major groups - soft goods, durable goods, and miscellaneous goods, and (c) a store total, which covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE
INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100, unless otherwise noted)

Groups	Dec. 1995	Dec. 1996	Percent Change from Dec. 1995 to Dec. 1996[1]
1. Piece Goods	532.6	538.7	1.1
2. Domestics and Draperies	633.5	636.6	0.5
3. Women's and Children's Shoes	625.6	646.0	3.3
4. Men's Shoes	891.0	894.2	0.4
5. Infants' Wear	635.6	616.8	−3.0
6. Women's Underwear	521.6	527.1	1.1
7. Women's Hosiery	290.2	287.2	−1.0
8. Women's and Girls' Accessories	559.9	556.4	−0.6
9. Women's Outerwear and Girls' Wear	407.1	404.4	−0.7
10. Men's Clothing	602.1	610.8	1.4
11. Men's Furnishings	561.6	578.6	3.0
12. Boys' Clothing and Furnishings	481.8	483.5	0.4
13. Jewelry	978.1	965.3	−1.3
14. Notions	773.6	779.4	0.7
15. Toilet Articles and Drugs	870.8	904.3	3.8
16. Furniture and Bedding	669.0	664.6	−0.7
17. Floor Coverings	564.5	574.8	1.8
18. Housewares	782.3	806.1	3.0
19. Major Appliances	246.1	245.3	−0.3
20. Radio and Television	79.1	78.1	−1.3
21. Recreation and Education[2]	112.8	110.8	−1.8
22. Home Improvements[2]	123.7	132.2	6.9
23. Auto Accessories[2]	107.5	107.3	−0.2
Groups 1 - 15: Soft Goods	585.1	589.8	0.8
Groups 16 - 20: Durable Goods	462.2	466.6	1.0
Groups 21 - 23: Misc. Goods[2]	113.3	112.9	−0.4
Store Total[3]	543.7	547.4	0.7

[1]Absence of a minus sign before percentage change in this column signifies price increase.
[2]Indexes on a January 1986=100 base.
[3]The store total index covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

DRAFTING INFORMATION

The principal author of this revenue ruling is Stan Michaels of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Michaels on (202) 622-4970 (not a toll-free call).

Section 475.—Mark to Market Accounting Method for Dealers in Securities

26 CFR 1.475(c)–1: Definitions—dealers in securities.

T.D. 8700

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 602

Mark to Market for Dealers in Securities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final regulations providing guidance to enable taxpayers to comply with the mark-to-market requirements applicable to dealers in securities. The Revenue Reconciliation Act of 1993 amended the applicable tax law. These regulations provide guidance to dealers in securities.

DATES: These final regulations are effective December 24, 1996, except paragraph (a) of § 1.475(c)–1T is removed effective December 24, 1996, and the remainder of § 1.475(c)–1T is removed effective January 23, 1997.

For dates of applicability, see § 1.475(e)–1.

FOR FURTHER INFORMATION CONTACT: Robert B. Williams at (202) 622–3960 or Jo Lynn Ricks at (202) 622–3920 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1496. Responses to this collection of information are required for a taxpayer to obtain the benefit of an exemption from marking to market under section 475 for those securities (see § 1.475(b)–2) and for a consolidated group of taxpayers to obtain the benefit of treating inter-member transactions as customer transactions for purposes of the definition of dealer in securities (the intragroup-customer election, § 1.475-(c)–1(a)(3)(iii)).

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The estimated annual burden per recordkeeper regarding § 1.475(b)–2 varies from .25 to 3 hours, depending on individual circumstances, with an estimated average of 1 hour. Section 1.475(b)–4 (formerly § 1.475(b)–2T), which permitted a taxpayer to add or remove certain identifications on or before January 31, 1994, does not impose a recordkeeping burden into the future. The estimated burden per respondent in making the intragroup-customer election in §§ 1.475(c)–1(a)(3)(iii) varies from .25 to 1 hours, depending on individual circumstances, with an estimated average of .5 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service,** Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224, and to the **Office of Management and Budget,** Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to this collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains final regulations under section 475 (relating to mark-to-market accounting for dealers in securities). Section 475 was added by section 13223 of the Revenue Reconciliation Act of 1993, Public Law 103–66, 107 Stat. 481, and is effective for all taxable years ending on or after December 31, 1993.

On December 29, 1993, temporary regulations (T.D. 8505, [1994–1 C.B. 152] 58 FR 68747) (hereinafter sometimes referred to as the temporary regulations) and cross-referenced proposed regulations (FI–72–93, 58 FR 68798) (hereinafter sometimes referred to as the 1993 proposed regulations) were published to furnish guidance on several issues, including the scope of exemptions from the mark-to-market requirements, certain transitional issues relating to the scope of exemptions, and the meaning of the statutory terms *security*, *dealer in securities*, and *held for investment*. Various comments were received regarding those regulations, and a hearing was held on April 12, 1994.

Additional regulations were proposed on January 4, 1995 (60 FR 397) (hereinafter sometimes referred to as the 1995 proposed regulations), and on June 20, 1996 (61 FR 31474) (hereinafter sometimes referred to as the 1996 proposed regulations). The 1995 and 1996 proposed regulations supplemented, and in a few cases revised, the 1993 proposed regulations. Hearings on the 1995 and 1996 proposed regulations were held on May 3, 1995, and October 15, 1996, respectively.

The final regulations in this document generally adopt the 1993 proposed regulations, as revised by the 1995 and 1996 proposed regulations, with certain changes reflecting comments that were received. These final regulations also adopt additional portions of the 1995 proposed regulations. The sections that are not adopted at this time remain proposed.

The provisions governing mark to market of debt instruments, which were proposed in January 1995, attracted substantial comment. The IRS and Treasury intend to finalize those regulations in a substantially revised form in response to those taxpayer comments.

Explanation of Provisions

Acquisition by a dealer of a security with a substituted basis

The final regulations adopt without change the provisions in the 1995 proposed regulations that provide rules for situations where a dealer in securities receives a security with a basis in its hands that is determined, in whole or in part, either by reference to the basis of the security in the hands of the transferor or by reference to other property held at any time by the dealer. In these cases, section 475(a) applies only to post-acquisition gain and loss with respect to the security. That is, section 475(a) applies only to changes in value of the security occurring after its acquisition. See section 475(b)(3). The character of the mark-to-market gain or loss is determined as provided under section 475(d)(3). The character of pre-acquisition gain or loss (that is, the built-in gain or loss at the date the dealer acquires the security) and the time for taking that gain or loss into account are determined without regard to section 475. The fact that a security has a substituted basis in the dealer's hands does not affect the security's date of acquisition for purposes of determining the timeliness of an identification under section 475(b).

Scope of Exemptions From Mark-To-Market Requirement

Section 475(b) exempts certain securities from mark-to-market accounting under section 475(a). Among the exempted securities are those held for investment and debt securities not held for sale. Section 1.475(b)–1(a) of the regulations, like the temporary rule that preceded it, provides that held for investment, as used in section 475(b)(1)(A), and not held for sale, as used in section 475(b)(1)(B), have the same meaning. The regulations provide that both terms refer to a security that is not held by a taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business. By providing that a security is held for investment (or not held for sale) if it is not held primarily for sale to customers in the ordinary course of a trade or business, the regulations adopt the concept of held for investment in section 1236(a). Thus, under these regulations, a dealer in securities may identify as held for investment a security that it holds primarily for sale to non-customers (for example, a trading security). The IRS and the Treasury believe that providing a single standard for purposes of sections 475 and 1236 is consistent with the purpose of section 475. These rules apply to taxable years ending on or after December 31, 1993.

The final regulations require a taxpayer that identifies a security as exempt from being marked to market to state (on its books and records) whether the security is, on the one hand, exempt as held for investment or not held for sale or, on the other hand, exempt because it is a hedge of an item not subject to mark to market. This regulation applies to identifications made on or after July 1, 1997.

The temporary and 1993 proposed regulations provide that stock in a 50-percent-controlled subsidiary, and interests in 50-percent-controlled partnerships and trusts, are deemed properly identified as held for investment and thus are excluded from mark-to-market accounting. The 1996 proposed regulations reproposed this rule with two changes. First, the IRS believed that the rationale for the rule applies equally to equity interests in most related persons and not just to persons controlled by the taxpayer. Second, after considering various comments received, the IRS proposed that this rule prohibiting marking a security to market should not apply if two requirements are met: (1) the security is actively traded on a national securities exchange or through an interdealer quotation system; and (2) the taxpayer who marks owns less than 5 percent of all shares or interests of the same class. Comments were requested as to whether it is appropriate to allow any equity interests in related parties to be marked to market, and, if so, whether the proposed limitations are the most appropriate ones.

After considering the comments received in response, the IRS and the Treasury have decided to adopt the provisions in the 1996 proposed regulations with certain modifications. First, the general threshold above which even actively traded stock in a related party may not be marked to market has been increased from 5% to 15%. The 15% limit, however, includes shares held both by the dealer and by certain related parties. Second, shares that a dealer acquires from a related party cannot be marked to market unless, after the time they were acquired, both one full business day has passed and there has been significant trading in the security involving persons who are not related to the taxpayer.

Section 475(b)(3) applies when a security has been exempt from marking to market and the exemption then ceases to apply. Thus, changes in a security's value that occur while section 475(a) does not apply are suspended. This rule has additional significance for certain members of consolidated groups because § 1.1502–13(f)(6) disallows certain losses recognized by members of consolidated groups on common parent stock if the loss is not taken into account pursuant to section 475(a).

The final regulations provide that, except as determined by the Commissioner, notional principal contracts and derivative securities described in section 475(c)(2)(D) or (E) that are held by a dealer in those securities are not eligible to be exempted from mark-to-market treatment as held for investment.

Under the temporary and 1993 proposed regulations, however, an analogous barrier to exemption from mark-to-market treatment did not apply if the taxpayer established unambiguously that the security was acquired other than in the taxpayer's capacity as a dealer in such securities. It was anticipated that this exception would apply only in rare instances. Commenters suggested an easing of the standard for establishing that a security was acquired other than in the taxpayer's capacity as a dealer in such securities.

These suggestions are specifically rejected in the final regulations set forth in § 1.475(b)–1(c). Instead, as described above, to avoid uncertainty and ambiguity, the rule barring exemption from mark-to-market treatment for certain notional principal contracts and derivative securities applies unless the Commissioner explicitly determines otherwise. For securities acquired or entered into before January 23, 1997, however, the final regulations continue the rule found in the temporary regulations.

Commenters suggested that changes are needed to allow taxpayers that are dealers in notional principal contracts and derivative securities (described in section 475(c)(2)(D) or (E)) to identify as exempt from mark-to-market treatment a notional principal contract or derivative that is held as a hedge of a position that is not marked to market.

No change was made to the temporary regulations to reflect these comments because none was necessary. Section 1.475(b)–1(c) limits exemptions only under section 475(b)(1)(A) (concerning securities held for investment). Section 1.475(b)–1(c) does not limit exemptions under section 475(b)(1)(C) (concerning securities that are hedges of non-mark-to-market positions). Although the flush language at the end of section 475(b)(1) authorizes analogous regulatory limitations on exemption under section 475(b)(1)(C), as of this time, no such regulation has been issued or proposed. Accordingly, if a dealer in notional principal contracts or derivatives enters into a notional principal contract or derivative as a hedge of a position that is not marked to market, the dealer may properly identify it under section 475(b)(1)(C) as exempt from mark-to-market treatment.

In response to comments, the final regulations expand the securities that a taxpayer may identify under section 475(b)(1)(C) as exempt from mark-to-market accounting. Under the final regulations, a taxpayer can identify as exempt from mark-to-market treatment under section 475(b)(1)(C) a security that hedges a position of another member of the taxpayer's consolidated group and meets the following three requirements: the security is a hedging transaction within the meaning of § 1.1221–2(b); the security is timely identified as a hedging transaction under § 1.1221–2(e) (including satisfaction of the requirement that the hedged item be identified); and the security hedges a position that is not marked to market under section 475(a). Although identification of the hedged item is not required under § 1.1221–2 until some time after the day the hedging transaction is entered into, the identification of the hedge under section 475(b)(2) must still be made no later than the close of the day on which the hedge is acquired, originated, or entered into.

Permitting taxpayers to identify these securities as exempt from mark-to-market accounting is consistent with the single-entity approach of the consolidated group hedging regulations under § 1.1221–2(d)(1). As a result of the identification, the timing of the gain or loss on the hedge is matched with the timing of the gain or loss on the hedged item without forcing taxpayers to use back-to-back hedges and the separate-entity election under § 1.1221–2(d)(2). This rule is effective for hedges entered into on or after January 23, 1997.

Exemptions—Transitional Issues

The final regulations adopt without substantive change a number of transitional rules relating to various exemption and identification issues. These transitional rules, now found in § 1.475(b)–4, were contained in § 1.475(b)–2T of the temporary regulations. A more complete description of these provisions may be found in the preamble of T.D. 8505 at 58 FR 68747 (1994–1 C.B. 152).

Dealer in Securities—the Dealer-Customer Relationship

The final regulations retain the rules in the 1995 proposed regulations concerning the dealer-customer relationship. Thus, the final regulations provide that determination of whether a transaction is with a customer is based on all of the facts and circumstances. Further, under section 475(c)(1)(B), the term *dealer in securities* includes a taxpayer that, in the ordinary course of its trade or business, regularly holds itself out as being willing and able to enter into either side of a transaction enumerated in section 475(c)(1)(B).

The final regulations retain the general rule in the 1996 proposed regulations that transactions with related persons may be transactions with customers for purposes of section 475. In response to comments, however, in § 1.475(c)–1(a)(3) the final regulations provide both a special rule for members of a consolidated group and an election for the rule not to apply. If the special rule applies, then, solely for purposes of determining whether the taxpayer meets the definition of a dealer in securities, a taxpayer's transactions with other members of its consolidated group are not transactions with customers. Thus, a member whose only customers are other members of its consolidated group generally is not a dealer in securities. Treating intragroup transactions as noncustomer transactions is consistent with the single-entity approach of §§ 1.1221–2(d)(1) and 1.1502–13. (The IRS expects to provide additional guidance on whether there are any circumstances in which the special rule applies for other purposes, such as whether a security may be exempted from mark-to-market treatment because it is not held for sale to customers.)

A consolidated group may elect not to apply the special rule. If a group has made this intragroup customer election, a member of a group may be a dealer in securities even if its only customer transactions are with other members of its consolidated group. Once made, the election continues for all subsequent taxable years and may be revoked only with the consent of the Commissioner.

These final regulations significantly alter the proposed default rule for intragroup transactions. Under the proposed regulations, a taxpayer's intragroup transactions would have been customer transactions for purposes of section 475. Because the final regulations reverse this rule (making noncustomer status the default and requiring an affirmative election to consider intragroup transactions in applying the dealer definition), the rules for intragroup transactions are effective for taxable years beginning on or after December 24, 1996. (The general rule for related party transactions other than intragroup transactions is effective for taxable years beginning on or after June 20, 1996.) The IRS will soon publish guidance to assist taxpayers who may have to change their methods of accounting because their status as a dealer changes as a result of the application of § 1.475(c)–1(a)(3).

For prior years, the Service generally will not challenge a taxpayer's treatment of intragroup transactions as customer or noncustomer transactions, provided the taxpayer had a reasonable basis for its treatment of the transactions and consistently applied that basis from year to year. In this regard, a taxpayer does not fail this consistency requirement solely because it changed its treatment of its intragroup transactions in order: (1) to avail itself of the separate-entity election under the consolidated group hedging regulations, or (2) to coincide with the expected effective date of either Notice 96–12 (1996–10 I.R.B. 29) or the related party rules in the 1996 proposed regulations. (If a taxpayer wishes to change its treatment of prior open years to be consistent with its status during the first year that § 1.475(c)–1(a)(3) applies, see § 301.9100–1T(a).)

Dealer in Securities—Sellers of Nonfinancial Goods and Services

In general, the final regulations exclude from dealer status any taxpayer that would not be a dealer in securities but for its purchases and sales of debt instruments that, at the time of purchase or sale, are customer debt with respect to the taxpayer or another member of the taxpayer's consolidated group. A debt instrument is customer debt at a particular time with respect to a person if three conditions are met: (1) the person's principal activity is selling nonfinancial goods or providing nonfinancial services; (2) the debt instrument was issued by a purchaser of the goods or services at the time of purchase of those items in order to finance their purchase; and (3) at all times after the debt instrument was issued, it has been owned by the person who sold the goods or services or by a member of its consolidated group. If, however, a taxpayer is a dealer in securities despite this provision, customer debt remains a security in the taxpayer's hands and must be marked to market unless exempted by another rule.

The temporary regulations contain a narrower provision—that a seller of nonfinancial goods or services is not a dealer in securities for purposes of section 475 solely by virtue of extending credit to its nonfinancial customers (even if it sells the debt instruments so acquired). In response to comments, the final regulations extend this principle to accommodate consolidated groups that include both a seller of nonfinancial goods or services and a captive finance subsidiary.

The rule in the final regulations exempting from dealer status most captive finance subsidiaries of retailers and other sellers of nonfinancial goods and services applies to all taxable years ending on or after December 31, 1993, unless the taxpayer elects for the exemption not to apply. If the election is made, it continues for all subsequent taxable years and may be revoked only with the consent of the Commissioner.

Under the final regulations, there are two additional circumstances in which this exemption from dealer status does not apply. The first is when, for purposes of the inventory accounting rules under section 471, the taxpayer accounts for any security (as defined in section 475(c)(2)) as inventory. The second circumstance is when the taxpayer is not itself the seller of nonfinancial goods and services and the customer debt is accounted for by the taxpayer or by a member of its consolidated group under a method that permits either the recognition of unrealized gains or losses or deductions for additions to a reserve for bad debts. This rule does not affect the seller of nonfinancial goods and services itself but is designed to prevent groups from having one captive finance subsidiary that is treated as a nondealer and another member of the group that is a dealer or a financial institution that accounts for customer debt under a method that takes into account mark-to-market gains or losses or reserve deductions.

Dealer in Securities—the Negligible Sales Exemption

Under the final regulations, in general, if a taxpayer purchases securities from customers (including originating loans in the ordinary course of the taxpayer's trade or business of originating loans) but engages in no more than negligible sales of the securities so acquired, the purchases do not cause the taxpayer to be a dealer in securities. This negligible sales rule does not apply if the taxpayer so elects or accounts for any security as inventory for purposes of section 471. A taxpayer that would be a dealer in securities but for the negligible sales rule elects to be a dealer simply by filing a federal income tax return reflecting the application of section 475(a) in computing its taxable income. The final regulations differ from the proposed regulations by explicitly making the negligible sales rule elective.

In response to comments, the final regulations clarify the test for determining negligible sales of debt instruments acquired from customers. Under this rule, a taxpayer has engaged in no more than negligible sales of the debt instruments (or portions of the debt instruments) that it regularly purchases from customers in the ordinary course of its business if, and only if, during the year, either (1) it sells all or part of fewer than 60 debt instruments (regardless how acquired), or (2) the total adjusted basis of the debt instruments or portions of debt instruments (regardless how acquired) that it sells is less than 5 percent of the total basis, immediately after acquisition, of the debt instruments that it acquires during the year.

This special test replaces the examples in the temporary regulations illustrating the negligible sales provision. Some commenters noted that § 1.475(c)–1T(b)(2) *Example 1* of the temporary regulations is ambiguous because it refers to a taxpayer that both ''retains almost all of the loans that it acquires'' and ''sells fewer than 60 loans.'' The final regulations eliminate the ambiguity by making no reference to how many loans are retained.

In response to comments, the final regulations contain two special rules for applying the negligible sales test to members of a consolidated group. Under the first rule, if a taxpayer is a member of a consolidated group that has made the intragroup-customer election, described above, it must apply the negligible sales test for debt instruments by taking into account all of its sales of debt instruments to other group members. On the other hand, if the taxpayer is a member of a consolidated group that has not made the intragroup-customer election, the negligible sales test is satisfied if either of two criteria is met: first, if the taxpayer satisfies the negligible sales test, taking into account all sales of debt instruments including sales to other group members; or second, if the taxpayer's consolidated group would satisfy the test if it were a single corporation and the members of the group were divisions of that corporation. This group-wide approach to the negligible sales test is consistent with the single-entity approach of §§ 1.1221–2(d)(1) and 1.1502–13.

Under a new rule in the final regulations, if a debt instrument is qualitatively different from all of the debt instruments that the taxpayer purchases from customers, a sale of that debt instrument does not count as one of the 60 instruments sold, and that debt instrument is not included in either the numerator or the denominator under the 5% test. The regulations contain an example that illustrates this principle.

The rules regarding the negligible sales exemption are generally effective for taxable years ending on or after December 31, 1993. The special rules for members of a consolidated group, however, are effective for taxable years beginning on or after January 23, 1997. Further, a taxpayer may rely on the rules set out in § 1.475(c)–1T(b) (as contained in 26 CFR part 1 revised April 1, 1996) for taxable years beginning before January 23, 1997, provided the taxpayer applies that paragraph reasonably and consistently.

Dealer in Securities—Issuance of Life Insurance Products

The final regulations adopt without change a provision in the 1995 proposed regulations to clarify that a life insurance company does not become a dealer in securities solely by selling annuity, endowment, or life insurance contracts to its customers.

Under the final regulations and the December 28, 1993, proposed regulations, a contract that is treated for federal income tax purposes as an annuity, endowment, or life insurance contract is deemed to have been identified as held for investment, and is therefore not marked to market by the policy holder. This rule was necessary because variable life and annuity products fall within the literal language of section 475(c)(2)(E). Because many life insurance companies sell these insurance contracts to their customers, some commenters on the 1993 proposal had asked whether these life insurance companies were dealers in securities. There is no indication that Congress intended for a life insurance company that was not otherwise a dealer in securities to be characterized as a dealer merely because it sells life insurance policies to its customers.

Several commenters requested that certain activities not cause dealer status under section 475 because those activities, although described by section 475, traditionally had not been considered dealer activities. Those comments were generally rejected. Congress determined that section 475 would bestow dealer status on taxpayers who had not been thought of as dealers prior to the enactment of section 475. Thus, the final regulations do not adopt proposals that making and selling policy loans should not cause an insurance company to be a dealer in securities and that sales of student loans or auto loans and sales of loan participations should not be taken into account in determining whether a taxpayer is a dealer in securities. Of course, if a lead bank never owns a particular portion of a loan for tax purposes (because some other participating lender always had the economic benefits and burdens of that portion), then the lead bank cannot sell that portion to that other participating lender. Thus, the lead bank is not a dealer in securities by reason of these participations.

Definition of Security

Under the final regulations, certain items are not securities within the meaning of section 475(c)(2). These items include both debt issued by the taxpayer and any security (determined without regard to this provision) if section 1032 bars recognition of gain or loss by the taxpayer with respect to that security.

The final regulations adopt without change the provisions in the 1995 proposed regulations that exclude from the definition of security all REMIC residual interests acquired on or after January 4, 1995. This rule was adopted because applying section 475 to residual interests would undermine the Congressional design for taxing REMIC income, including the intended operation of sections 860C and 860E (relating to excess inclusions).

Unlike the 1995 proposed regulations, the temporary regulations excluded only some residual interests from the definition of security. Specifically, the temporary regulations excluded only negative value residual interests (NVRIs) in a REMIC and other arrangements that are determined to have substantially the same economic effect as NVRIs. Under the final regulations, this exclusion continues to apply to NVRIs acquired before January 4, 1995.

One commenter acknowledged the tension between mark-to-market accounting and the excess inclusion rules, but proposed to address that problem in another way. Under the commenter's proposal, a dealer would be permitted to mark to market a residual interest, but any loss resulting from the mark would be taken into account only to the extent that the loss exceeded the amount of excess inclusion with respect to that residual interest for the taxable year.

The IRS and Treasury believe that this comment does not address the tension between mark-to-market accounting and section 860C. Apart from the excess inclusion rules, the REMIC provisions contemplate income inclusions (and corresponding basis increases) that are not necessarily associated with increases in the value of the residual interest. Under the commenter's proposal, a dealer could claim a loss by marking to market a residual interest where the increased basis in the interest resulted from an allocation of REMIC income that was unaccompanied by an increase in value. Thus, the dealer could avoid its allocable share of REMIC income and thereby frustrate the taxing regime contemplated for residual interests.

Moreover, adopting this comment would require additional, complex rules, and the burden of administering those rules would not be justified by the potential benefit. For example, under the proposal, a taxpayer would have one basis in a residual interest for purposes of section 475 and a different basis in the residual interest for purposes of section 860C(d). Also, adopting the proposal would require rules to coordinate losses that are limited under section 475 with losses that are limited under section 860C(e)(2).

Some commenters suggested that certain types of assets should not be marked to market because they may be difficult to value. Under section 475, however, ease of valuation is not relevant in determining whether a security is required to be marked to market.

Character of Gain or Loss

The regulations adopt without change the proposed provision to clarify that marking to market a security that is not held in connection with a taxpayer's activities as a dealer in securities does not affect the character of gain or loss from that security.

In addition, under a new provision in the final regulations that responds to comments from taxpayers, if a dealer in certain notional principal contracts or derivative securities (described in section 475(c)(2)(D) or (E)) marks those securities to market because it is precluded from identifying them as exempt from mark-to-market treatment on the grounds that they are held for investment, the dealer recognizes ordinary gain or loss with respect to those securities.

Effective Dates

These final regulations generally apply to taxable years ending on or after December 31, 1993, except as otherwise noted.

Miscellaneous

Some of the 1993 and 1995 proposed regulations are reordered.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. The collection of information required by § 1.475(b)–2 was contained in a notice of proposed rulemaking preceding these regulations that was issued prior to March 29, 1996. Moreover, it is hereby certified that the collection of information required by § 1.475(c)–1 of these regulations (regarding the intragroup customer election) does not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that the election is generally attractive only to an affiliated group of taxpayers that files a consolidated return (generally large businesses), that has elected separate entity treatment under § 1.1221–2, and that has an in-house hedge center or securities dealer which deals solely with other group members and which uses mark-to-market accounting for book purposes. Thus, the election is likely to be made only by, and the collection of information applies only to, a very small number of large taxpayers. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are Robert B. Williams and Jo Lynn Ricks, Office of Assistant Chief

Counsel (Financial Institutions and Products), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entries for §§ 1.475(b)–1T, 1.475(b)–2T, 1.475(c)–1T, 1.475(c)–2T, 1.475(d)–1T, and 1.475(e)–1T and adding entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805. * * *

Section 1.475(a)–3 also issued under 26 U.S.C. 475(e).

Section 1.475(b)–1 also issued under 26 U.S.C. 475(b)(4) and 26 U.S.C. 475(e).

Section 1.475(b)–2 also issued under 26 U.S.C. 475(b)(2) and 26 U.S.C. 475(e).

Section 1.475(b)–4 also issued under 26 U.S.C. 475(b)(2), 26 U.S.C. 475(e), and 26 U.S.C. 6001.

Section 1.475(c)–1 also issued under 26 U.S.C. 475(e).

Section 1.475(c)–2 also issued under 26 U.S.C. 475(e) and 26 U.S.C. 860G(e).

Section 1.475(d)–1 also issued under 26 U.S.C. 475(e).

Section 1.475(e)–1 also issued under 26 U.S.C. 475(e). * * *

Sections 1.475(b)–1T, 1.475(b)–2T, 1.475(c)–1T, 1.475(c)–2T, 1.475(d)–1T, and 1.475(e)–1T [Removed]

Par. 2. Sections 1.475(b)–1T, 1.475(b)–2T, 1.475(c)–2T, 1.475(d)–1T, and 1.475(e)–1T are removed.

Par. 2a. Paragraph (a) of § 1.475(c)–1T is removed effective December 24, 1996, and the remainder of § 1.475(c)–1T is removed January 23, 1997.

Par. 3. Sections 1.475–0, 1.475(a)–3, 1.475(b)–1, 1.475(b)–(2), 1.475(b)–4, 1.475(c)–1, 1.475(c)–2, 1.475(d)–1, and 1.475(e)–1 are added to read as follows:

§ 1.475–0 Table of contents.

This section lists the major captions in §§ 1.475(a)–3, 1.475(b)–1, 1.475(b)–2, 1.475(b)–4, 1.475(c)–1, 1.475(c)–2, 1.475(d)–1, and 1.475(e)–1.

(i) Intragroup-customer election in effect.

(ii) Intragroup-customer election not in effect.

(4) Special rules.

(5) Example.

(d) Issuance of life insurance products.

§ 1.475(c)–2 Definitions—security.

(a) Items that are not securities.

(b) Synthetic debt that § 1.1275–6(b) treats the taxpayer as holding.

(c) Negative value REMIC residuals acquired before January 4, 1995.

(1) Description.

(2) Special rules applicable to negative value REMIC residuals acquired before January 4, 1995.

§ 1.475(d)–1 Character of gain or loss.

(a) Securities never held in connection with the taxpayer's activities as a dealer in securities.

(b) Ordinary treatment for notional principal contracts and derivatives held by dealers in notional principal contracts and derivatives.

§ 1.475(e)–1 Effective dates.

§ 1.475(a)–3 Acquisition by a dealer of a security with a substituted basis.

(a) *Scope*. This section applies if—

(1) A dealer in securities acquires a security that is subject to section 475(a) and the dealer's basis in the security is determined, in whole or in part, by reference to the basis of that security in the hands of the person from whom the security was acquired; or

(2) A dealer in securities acquires a security that is subject to section 475(a) and the dealer's basis in the security is determined, in whole or in part, by reference to other property held at any time by the dealer.

(b) *Rules*. If this section applies to a security—

(1) Section 475(a) applies only to changes in value of the security occurring after the acquisition; and

(2) Any built-in gain or loss with respect to the security (based on the difference between the fair market value of the security on the date the dealer acquired it and its basis to the dealer on that date) is taken into account at the time, and has the character, provided by the sections of the Internal Revenue Code that would apply to the built-in gain or loss if section 475(a) did not apply to the security.

§ 1.475(b)–1 Scope of exemptions from mark-to-market requirement.

(a) *Securities held for investment or not held for sale*. Except as otherwise provided by this section and subject to the identification requirements of section 475(b)(2), a security is held for investment (within the meaning of section 475(b)(1)(A)) or not held for sale (within the meaning of section 475(b)(1)(B)) if it is not held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

(b) *Securities deemed identified as held for investment*— (1) *In general*. The following items held by a dealer in securities are per se held for investment within the meaning of section 475(b)(1)(A) and are deemed to be properly identified as such for purposes of section 475(b)(2)—

(i) Except as provided in paragraph (b)(3) of this section, stock in a corporation, or a partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust, to which the taxpayer has a relationship specified in paragraph (b)(2) of this section; or

(ii) A contract that is treated for federal income tax purposes as an annuity, endowment, or life insurance contract (see sections 72, 817, and 7702).

(2) *Relationships*—(i) *General rule*. The relationships specified in this paragraph (b)(2) are—

(A) Those described in section 267(b)(2), (3), (10), (11), or (12); or

(B) Those described in section 707(b)(1)(A) or (B).

(ii) *Attribution*. The relationships described in paragraph (b)(2)(i) of this section are determined taking into account sections 267(c) and 707(b)(3), as appropriate.

(iii) *Trusts treated as partnerships*. For purposes of this paragraph (b)(2), the phrase *partnership or trust* is substituted for the word *partnership* in sections 707(b)(1) and (3), and a reference to beneficial ownership interest is added to each reference to capital interest or profits interest in those sections.

(3) *Securities traded on certain established financial markets.* Paragraph (b)(1)(i) of this section does not apply to a security if—

(i) The security is actively traded within the meaning of § 1.1092(d)–1(a) taking into account only established financial markets identified in § 1.1092(d)–1(b)(1)(i) or (ii) (describing national securities exchanges and interdealer quotation systems);

(ii) Less than 15 percent of all of the outstanding shares or interests in the same class are held by the taxpayer and all persons having a relationship to the taxpayer that is specified in paragraph (b)(2) of this section; and

(iii) If the security was acquired (e.g., on original issue) from a person having a relationship to the taxpayer that is specified in paragraph (b)(2) of this section, then, after the time the security was acquired—

(A) At least one full business day has passed, and

(B) There has been significant trading involving persons not having a relationship to the taxpayer that is specified in paragraph (b)(2) of this section.

(4) *Changes in status*—(i) *Onset of prohibition against marking*—(A) Once paragraph (b)(1) of this section begins to apply to the security and for so long as it continues to apply, section 475(a) does not apply to the security in the hands of the taxpayer.

(B) If a security has not been timely identified under section 475(b)(2) and, after the last day on which such an identification would have been timely, paragraph (b)(1) of this section begins to apply to the security, then the dealer must recognize gain or loss on the security as if it were sold for its fair market value as of the close of business of the last day before paragraph (b)(1) of this section begins to apply to the security, and gain or loss is taken into account at that time.

(ii) *Termination of prohibition against marking*. If a taxpayer did not timely identify a security under section 475(b)(2), and paragraph (b)(1) of this section applies to the security on the last day on which such an identification would have been timely but thereafter ceases to apply—

(A) An identification of the security under section 475(b)(2) is timely if made on or before the close of the day paragraph (b)(1) of this section ceases to apply; and

(B) Unless the taxpayer timely identifies the security under section 475(b)(2) (taking into account the additional time for identification that is provided by paragraph (b)(4)(ii)(A) of this section), section 475(a) applies to changes in value of the security after the cessation in the same manner as under section 475(b)(3).

(iii) *Examples*. These examples illustrate this paragraph (b)(4):

Example 1. Onset of prohibition against marking—(A) *Facts.* Corporation *H* owns 75 percent of the stock of corporation *D*, a dealer in securities within the meaning of section 475(c)(1). On December 1, 1995, *D* acquired less than half of the stock in corporation *X*. *D* did not identify the stock for purposes of section 475(b)(2). On July 17, 1996, *H* acquired from other persons 70 percent of the stock of *X*. As a result, *D* and *X* became related within the meaning of paragraph (b)(2)(i) of this section. The stock of *X* is not described in paragraph (b)(3) of this section (concerning some securities traded on certain established financial markets).

(B) *Holding.* Under paragraph (b)(4)(i) of this section, *D* recognizes gain or loss on its *X* stock as if the stock were sold for its fair market value at the close of business on July 16, 1996, and the gain or loss is taken into account at that time. As with any application of section 475(a), proper adjustment is made in the amount of any gain or loss subsequently realized. After July 16, 1996, section 475(a) does not apply to *D*'s *X* stock while paragraph (b)(1)(i) of this section (concerning the relationship between *X* and *D*) continues to apply.

Example 2. Termination of prohibition against marking; retained securities identified as held for investment—(A) *Facts.* On July 1, 1996, corporation *H* owned 60 percent of the stock of corporation *Y* and all of the stock of corporation *D*, a dealer in securities within the meaning of section 475(c)(1). Thus, *D* and *Y* are related within the meaning of paragraph (b)(2)(i) of this section. Also on July 1, 1996, *D* acquired, as an investment, 10 percent of the stock of *Y*. The stock of *Y* is not described in paragraph (b)(3) of this section (concerning some securities traded on certain established financial markets). When *D* acquired its shares of *Y* stock, it did not identify them for purposes of section 475(b)(2). On December 24, 1996, *D* identified its shares of *Y* stock as held for investment under section 475(b)(2). On December 30, 1996, *H* sold all of its shares of stock in *Y* to an unrelated party. As a result, *D* and *Y* ceased to be related within the meaning of paragraph (b)(2)(i) of this section.

(B) *Holding.* Under paragraph (b)(4)(ii)(A) of this section, identification of the *Y* shares is timely if done on or before the close of December 30, 1996. Because *D* timely identified its *Y* shares under section 475(b)(2), it continues after December 30, 1996, to refrain from marking to market its *Y* stock.

Example 3. Termination of prohibition against marking; retained securities not identified as held for investment— (A) *Facts.* The facts are the same as in *Example 2* above, except that *D* did not identify its stock in *Y* for purposes of section 475(b)(2) on or before December 30, 1996. Thus, *D* did not timely identify these securities under section 475(b)(2) (taking into account the additional time for identification provided in paragraph (b)(4)(ii)(A) of this section).

(B) *Holding.* Under paragraph (b)(4)(ii)(B) of this section, section 475(a) applies to changes in value of *D*'s *Y* stock after December 30, 1996, in the same manner as under section 475(b)(3). Thus, any appreciation or depreciation that occurred while the securities were prohibited from being marked to market is suspended. Further, section 475(a) applies only to those changes occurring after December 30, 1996.

Example 4. Acquisition of actively traded stock from related party—(A) *Facts*. Corporation *P* is the parent of a consolidated group whose taxable year is the calendar year, and corporation *M*, a member of that group, is a dealer in securities within the meaning of section 475(c)(1). Corporation *M* regularly acts as a market maker with respect to common and preferred stock of corporation *P*. Corporation *P* has outstanding 2,000,000 shares of series *X* preferred stock, which are traded on a national securities exchange. During the business day on December 29, 1997, corporation *P* sold 100,000 shares of series *X* preferred stock to corporation *M* for $100 per share. Subsequently, also on December 29, 1997, persons not related to corporation *M* engaged in significant trading of the series *X* preferred stock. At the close of business on December 30, 1997, the fair market value of series *X* stock was $99 per share. At the close of business on December 31, 1997, the fair market value of series *X* stock was $98.50 per share. Corporation *M* sold the series *X* stock on the exchange on January 2, 1998. At all relevant times, corporation *M* and all persons related to *M* owned less than 15% of the outstanding series *X* preferred stock.

(B) *Holding.* The 100,000 shares of series *X* preferred stock held by corporation *M* are not subject to mark-to-market treatment under section 475(a) on December 29, 1997, because at that time the stock was held for less than one full business day and is therefore treated as properly identified as held for investment. At the close of business on December 30, 1997, that prohibition on marking ceases to apply, and section 475(b)(3) begins to apply. The built-in loss is suspended, and subsequent appreciation and depreciation are subject to section 475(a). Accordingly, when corporation *M* marks the series *X* stock to market at the close of business on December 31, 1997, under section 475(a) it recognizes and takes into account a loss of $.50 per share. Under section 475(b)(3), when corporation *M* sells the series *X* stock on January 2, 1998, it takes into account the suspended loss, that is, the difference between the $100 per share it paid corporation *P* for that stock and the $99-per-share fair market value when section 475(b)(1) ceased to be apply to the stock. No deduction, however, is allowed for that loss. (See § 1.1502–13(f)(6), under which no deduction is allowed to a member of a consolidated group for a loss with respect to a share of stock of the parent of that consolidated group, if the member does not take the gain or loss into account pursuant to section 475(a).)

(c) *Securities deemed not held for investment; dealers in notional principal contracts and derivatives*—(1) Except as otherwise determined by the Commissioner in a revenue ruling, revenue procedure, or letter ruling, section 475(b)(1)(A) (exempting from mark-to-market accounting certain securities that are held for investment) does not apply to a security if—

(i) The security is described in section 475(c)(2)(D) or (E) (describing certain notional principal contracts and derivative securities); and

(ii) The taxpayer is a dealer in such securities.

(2) See § 1.475(d)–1(b) for a rule concerning the character of gain or loss on securities described in this paragraph (c).

(d) *Special rule for hedges of another member's risk.* A taxpayer may identify under section 475(b)(1)(C) (exempting certain hedges from mark-to-market accounting) a security that hedges a position of another member of the taxpayer's consolidated group if the security meets the following requirements—

(1) The security is a hedging transaction within the meaning of § 1.1221–2(b);

(2) The security is timely identified as a hedging transaction under § 1.1221–2(e) (including identification of the hedged item); and

(3) The security hedges a position that is not marked to market under section 475(a).

(e) *Transitional rules*—(1) *Stock, partnership, and beneficial ownership interests in certain controlled corporations, partnerships, and trusts before January 23, 1997*— (i) *In general*. The following items held by a dealer in securities are per se held for investment within the meaning of section 475(b)(1)(A) and are deemed to be properly identified as such for purposes of section 475(b)(2)—

(A) Stock in a corporation that the taxpayer controls (within the meaning of paragraph (e)(1)(ii) of this section); or

(B) A partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust that the taxpayer controls (within the meaning of paragraph (e)(1)(ii) of this section).

(ii) *Control defined*. Control means the ownership, directly or indirectly through persons described in section 267(b) (taking into account section 267(c)), of—

(A) 50 percent or more of the total combined voting power of all classes of stock entitled to vote; or

(B) 50 percent or more of the capital interest, the profits interest, or the beneficial ownership interest in the widely held or publicly traded partnership or trust.

(iii) *Applicability*. The rules of this paragraph (e)(1) apply only before January 23, 1997.

(2) *Dealers in notional principal contracts and derivatives acquired before January 23, 1997*—(i) *General rule*. Section 475(b)(1)(A) (exempting certain securities from mark-to-market accounting) does not apply to a security if—

(A) The security is described in section 475(c)(2)(D) or (E) (describing certain notional principal contracts and derivative securities); and

(B) The taxpayer is a dealer in such securities.

(ii) *Exception for securities not acquired in dealer capacity.* This paragraph (e)(2) does not apply if the taxpayer establishes unambiguously that the security was not acquired in the taxpayer's capacity as a dealer in such securities.

(iii) *Applicability*. The rules of paragraph (e)(2) apply only to securities acquired before January 23, 1997.

§ 1.475(b)–2 Exemptions—identification requirements.

(a) *Identification of the basis for exemption.* An identification of a security as exempt from mark to market does not satisfy section 475(b)(2) if it fails to state whether the security is described in—

(1) Either of the first two subparagraphs of section 475(b)(1) (identifying a security as held for investment or not held for sale); or

(2) The third subparagraph thereof (identifying a security as a hedge).

(b) *Time for identifying a security with a substituted basis.* For purposes of determining the timeliness of an identification under section 475(b)(2), the date that a dealer acquires a security is not affected by whether the dealer's basis in the security is determined, in whole or in part, either by reference to the basis of the security in the hands of the person from whom the security was acquired or by reference to other property held at any time by the dealer. See § 1.475(a)–3 for rules governing how the dealer accounts for such a security if this identification is not made.

(c) *Integrated transactions under § 1.1275–6*— (1) *Definitions.* The following terms are used in this paragraph (c) with the meanings that are given to them by § 1.1275–6: integrated transaction, legging into, legging out, qualifying debt instrument, § 1.1275–6 hedge, and synthetic debt instrument.

(2) *Synthetic debt held by a taxpayer as a result of legging in.* If a taxpayer is treated as the holder of a synthetic debt instrument as the result of legging into an integrated transaction, then, for purposes of the timeliness of an identification under section 475(b)(2), the synthetic debt instrument is treated as having the same acquisition date as the qualifying debt instrument. A pre-leg-in identification of the qualifying debt instrument under section 475(b)(2) applies to the integrated transaction as well.

(3) *Securities held after legging out.* If a taxpayer legs out of an integrated transaction, then, for purposes of the timeliness of an identification under section 475(b)(2), the qualifying debt instrument, or the § 1.1275–6 hedge, that remains in the taxpayer's hands is generally treated as having been acquired, originated, or entered into, as the case may be, immediately after the leg-out. If any loss or deduction determined under § 1.1275–6(d)(2)(ii)(B) is disallowed by § 1.1275–6(d)(2)(ii)(D) (which disallows deductions when a taxpayer legs out of an integrated transaction within 30 days of legging in), then, for purposes of this section and section 475(b)(2), the qualifying debt instrument that remains in the taxpayer's hands is treated as having been acquired on the same date that the synthetic debt instrument was treated as having been acquired.

§ 1.475(b)–4 Exemptions—transitional issues.

(a) *Transitional identification*—(1) *Certain securities previously identified under section 1236.* If, as of the close of the last taxable year ending before December 31, 1993, a security was identified under section 1236 as a security held for investment, the security is treated as being identified as held for investment for purposes of section 475(b).

(2) *Consistency requirement for other securities.* In the case of a security (including a security described in section 475(c)(2)(F)) that is not described in paragraph (a)(1) of this section and that was held by the taxpayer as of the close of the last taxable year ending before December 31, 1993, the security is treated as having been properly identified under section 475(b)(2) or 475(c)(2)(F)(iii) if the information contained in the dealer's books and records as of the close of that year supports the identification. If there is any ambiguity in those records, the taxpayer must, no later than January 31, 1994, place in its records a statement resolving this ambiguity and indicating unambiguously which securities are to be treated as properly identified. Any information that supports treating a security as having been properly identified under section 475(b)(2) or (c)(2)(F)(iii) must be applied consistently from one security to another.

(b) *Corrections on or before January 31, 1994*—(1) *Purpose.* This paragraph (b) allows a taxpayer to add or remove certain identifications covered by § 1.475(b)–1.

(2) *To conform to § 1.475(b)–1(a)*—(i) *Added identifications.* To the extent permitted by paragraph (b)(2)(ii) of this section, a taxpayer may identify as being described in section 475(b)(1)(A) or (B)—

(A) A security that was held for immediate sale but was not held primarily for sale to customers in the ordinary course of the taxpayer's trade or business (for example, a trading security); or

(B) An evidence of indebtedness that was not held for sale to customers in the ordinary course of the taxpayer's trade or business and that the taxpayer intended to hold for less than one year.

(ii) *Limitations.* An identification described in paragraph (b)(2)(i) of this section is permitted only if—

(A) Prior to December 28, 1993, the taxpayer did not identify as being described in section 475(b)(1)(A) or (B) any of the securities described in paragraph (b)(2)(i) of this section;

(B) The taxpayer identifies every security described in paragraph (b)(2)(i) of this section for which a timely identification of the security under section 475(b)(2) cannot be made after the date on which the taxpayer makes these added identifications; and

(C) The identification is made on or before January 31, 1994.

(3) *To conform to § 1.475(b)–1(c).* On or before January 31, 1994, a taxpayer described in § 1.475(b)–1(e)(2)(i)(B) may remove an identification under section 475(b)(1)(A) of a security described in § 1.475(b)–1(e)(2)(i)(A).

(c) *Effect of corrections.* An identification added under paragraph (a)(2) or (b)(2) of this section is timely for purposes of section 475(b)(2) or (c)(2)(F)(iii). An identification removed under paragraph (a)(2) or (b)(3) of this section does not subject the taxpayer to the provisions of section 475(d)(2).

§ 1.475(c)–1 Definitions—dealer in securities.

(a) *Dealer-customer relationship.* Whether a taxpayer is transacting business with customers is determined on the basis of all of the facts and circumstances.

(1) [Reserved].

(2) *Transactions described in section 475(c)(1)(B)*—(i) *In general.* For purposes of section 475(c)(1)(B), the term

dealer in securities includes, but is not limited to, a taxpayer that, in the ordinary course of the taxpayer's trade or business, regularly holds itself out as being willing and able to enter into either side of a transaction enumerated in section 475(c)(1)(B).

(ii) *Examples*. The following examples illustrate the rules of this paragraph (a)(2). In the following examples, *B* is a bank and is not a member of a consolidated group:

Example 1. B regularly offers to enter into interest rate swaps with other persons in the ordinary course of its trade or business. B is willing to enter into interest rate swaps under which it either pays a fixed interest rate and receives a floating rate or pays a floating rate and receives a fixed rate. B is a dealer in securities under section 475(c)(1)(B), and the counterparties are its customers.

Example 2. B, in the ordinary course of its trade or business, regularly holds itself out as being willing and able to enter into either side of positions in a foreign currency with other banks in the interbank market. B's activities in the foreign currency make it a dealer in securities under section 475(c)(1)(B), and the other banks in the interbank market are its customers.

Example 3. B engages in frequent transactions in a foreign currency in the interbank market. Unlike the facts in *Example 2*, however, *B* does not regularly hold itself out as being willing and able to enter into either side of positions in the foreign currency, and all of *B*'s transactions are driven by its internal need to adjust its position in the currency. No other circumstances are present to suggest that *B* is a dealer in securities for purposes of section 475(c)(1)(B). *B*'s activity in the foreign currency does not qualify it as a dealer in securities for purposes of section 475(c)(1)(B), and its transactions in the interbank market are not transactions with customers.

(3) *Related parties*—(i) *General rule.* Except as provided in paragraph (a)(3)(ii) of this section (concerning transactions between members of a consolidated group, as defined in § 1.1502–1(h)), a taxpayer's transactions with related persons may be transactions with customers for purposes of section 475. For example, if a taxpayer, in the ordinary course of the taxpayer's trade or business, regularly holds itself out to its foreign subsidiaries or other related persons as being willing and able to enter into either side of transactions enumerated in section 475(c)(1)(B), the taxpayer is a dealer in securities within the meaning of section 475(c)(1), even if it engages in no other transactions with customers.

(ii) *Special rule for members of a consolidated group.* Solely for purposes of paragraph (c)(1) of section 475 (concerning the definition of dealer in securities) and except as provided in paragraph (a)(3)(iii) of this section, a taxpayer's transactions with other members of its consolidated group are not with customers. Accordingly, notwithstanding paragraph (a)(2) of this section, the fact that a taxpayer regularly holds itself out to other members of its consolidated group as being willing and able to enter into either side of a transaction enumerated in section 475(c)(1)(B) does not cause the taxpayer to be a dealer in securities within the meaning of section 475(c)(1)(B).

(iii) *The intragroup-customer election*—(A) *Effect of election.* If a consolidated group makes the intragroup-customer election, paragraph (a)(3)(ii) of this section (special rule for members of a consolidated group) does not apply to the members of the group. Thus, a member of a group that has made this election may be a dealer in securities within the meaning of section 475(c)(1) even if its only customer transactions are with other members of its consolidated group.

(B) *Making and revoking the election.* Unless the Commissioner otherwise prescribes, the intragroup-customer election is made by filing a statement that says, ''[Insert name and employer identification number of common parent] hereby makes the Intragroup-Customer Election (as described in § 1.475(c)–1(a)(3)(iii) of the income tax regulations) for the taxable year ending [describe the last day of the year] and for subsequent taxable years.'' The statement must be signed by the common parent and attached to the timely filed federal income tax return for the consolidated group for that taxable year. The election applies for that year and continues in effect for subsequent years until revoked. The election may be revoked only with the consent of the Commissioner.

(iv) *Examples.* The following examples illustrate this paragraph (a)(3):

General Facts. HC, a hedging center, provides interest rate hedges to all of the members of its affiliated group (as defined in section 1504(a)(1)). Because of the efficiencies created by having a centralized risk manager, group policy prohibits members other than *HC* from entering into derivative interest rate positions with outside parties. *HC* regularly holds itself out as being willing and able to, and in fact does, enter into either side of interest rate swaps with its fellow members. *HC* periodically computes its aggregate position and hedges the net risk with an unrelated party. *HC* does not otherwise enter into interest rate positions with persons that are not members of the affiliated group. *HC* attempts to operate at cost, and the terms of its swaps do not factor in any risk of default by the affiliate. Thus, *HC*'s affiliates receive somewhat more favorable terms then they would receive from an unrelated swaps dealer (a fact that may subject *HC* and its fellow members to reallocation of income under section 482). No other circumstances are present to suggest that *HC* is a dealer in securities for purposes of section 475(c)(1)(B).

Example 1. General rule for related persons. In addition to the *General Facts* stated above, assume that *HC*'s affiliated group has not elected under section 1501 to file a consolidated return. Under paragraph (a)(3)(i) of this section, *HC*'s transactions with its affiliates can be transactions with customers for purposes of section 475(c)(1). Thus, under paragraph (a)(2)(i) of this section, *HC* is a dealer in securities within the meaning of section 475(c)(1)(B), and the members of the group with which it does business are its customers.

Example 2. Special rule for members of a consolidated group. In addition to the *General Facts* stated above, assume that *HC*'s affiliated group has elected to file consolidated returns and has not made the intragroup-customer election. Under paragraph (a)(3)(ii) of this section, *HC*'s interest rate swap transactions with the members of its consolidated group are not transactions with customers for purposes of determining whether *HC* is a dealer in securities within the meaning of section 475(c)(1). Further, the fact that *HC* regularly holds itself out to members of its consolidated group as being willing and able to enter into either side of a transaction enumerated in section 475(c)(1)(B) does not cause *HC* to be a dealer in securities within the meaning of section 475(c)(1)(B). Because no other circumstances are present to suggest that *HC* is a dealer in securities for purposes of section 475(c)(1)(B), *HC* is not a dealer in securities.

Example 3. Intragroup-customer election. In addition to the *General Facts* stated above, assume that *HC*'s affiliated group has elected to file a consolidated return but has also made the intragroup-customer election under paragraph (a)(3)(iii) of this section. Thus, the analysis and result are the same as in *Example 1.*

(b) *Sellers of nonfinancial goods and services*— (1) *Purchases and sales of customer paper.* Except as provided in paragraph (b)(3) of this section, if a taxpayer would not be a dealer in securities within the meaning of section 475(c)(1) but for its purchases and sales of debt instruments that, at the time of purchase or sale, are customer paper with respect to either the taxpayer or a corporation that is a member of the same consolidated group (as defined in § 1.1502–1(h)) as the taxpayer, then for purposes of section 475 the taxpayer is not a dealer in securities.

(2) *Definition of customer paper.* A debt instrument is customer paper with respect to a person at a point in time if—

(i) The person's principal activity is selling nonfinancial goods or providing nonfinancial services;

(ii) The debt instrument was issued by a purchaser of the goods or services at the time of the purchase of those goods or services in order to finance the purchase; and

(iii) At all times since the debt instrument was issued, it has been held either by the person selling those goods or services or by a corporation that is a member of the same consolidated group as that person.

(3) *Exceptions.* Paragraph (b)(1) of this section does not apply if—

(i) For purposes of section 471, the taxpayer accounts for any security (as defined in section 475(c)(2)) as inventory;

(ii) The taxpayer is subject to an election under paragraph (b)(4) of this section; or

(iii) The taxpayer is not described in paragraph (b)(2)(i) of this section and one or more debt instruments that are customer paper with respect to a corporation that is a member of the same consolidated group as the taxpayer are accounted for by the taxpayer, or by a corporation that is a member of the same consolidated group as the taxpayer, in a manner that allows recognition of unrealized gains or losses or deductions for additions to a reserve for bad debts.

(4) *Election not to be governed by the exception for sellers of nonfinancial goods or services*—(i) *Method of making the election.* Unless the Commissioner otherwise prescribes, an election under this paragraph (b)(4) must be made in the manner, and at the time, prescribed in this paragraph (b)(4)(i). The taxpayer must file with the Internal Revenue Service a statement that says, ''[Insert name and taxpayer identification number of the taxpayer] hereby elects not to be governed by § 1.475(c)–1(b)(1) of the income tax regulations for the taxable year ending [describe the last day of the year] and for subsequent taxable years.''

(A) *Taxable years ending after December 24, 1996.* If the first taxable year subject to an election under this paragraph (b)(4) ends after December 24, 1996, the statement must be attached to a timely filed federal income tax return for that taxable year.

(B) *Taxable years ending on or before December 24, 1996.* If the first taxable year subject to an election under this paragraph (b)(4) ends on or before December 24, 1996, and the election changes the taxpayer's taxable income for any taxable year the federal income tax return for which was filed before February 24, 1997, the statement must be attached to an amended return for the earliest such year that is so affected, and that amended return (and an amended return for any other such year that is so affected) must be filed not later than June 23, 1997. If the first taxable year subject to an election under this paragraph (b)(4) ends on or before December 24, 1996, but the taxpayer is not described in the preceding sentence, the statement must be attached to the first federal income tax return that is for a taxable year subject to the election and that is filed on or after February 24, 1997.

(ii) *Continued applicability of an election.* An election under this paragraph (b)(4) continues in effect for subsequent taxable years until revoked. The election may be revoked only with the consent of the Commissioner.

(c) *Taxpayers that purchase securities from customers but engage in no more than negligible sales of the securities*—(1) *Exemption from dealer status*—(i) *General rule.* A taxpayer that regularly purchases securities from customers in the ordinary course of a trade or business (including regularly making loans to customers in the ordinary course of a trade or business of making loans) but engages in no more than negligible sales of the securities so acquired is not a dealer in securities within the meaning of section 475(c)(1) unless the taxpayer elects to be so treated or, for purposes of section 471, the taxpayer accounts for any security (as defined in section 475(c)(2)) as inventory.

(ii) *Election to be treated as a dealer.* A taxpayer described in paragraph (c)(1)(i) of this section elects to be treated as a dealer in securities by filing a federal income tax return reflecting the application of section 475(a) in computing its taxable income.

(2) *Negligible sales.* Solely for purposes of paragraph (c)(1) of this section, a taxpayer engages in negligible sales of debt instruments that it regularly purchases from customers in the ordinary course of its business if, and only if, during the taxable year, either—

(i) The taxpayer sells all or part of fewer than 60 debt instruments, regardless how acquired; or

(ii) The total adjusted basis of the debt instruments (or parts of debt instruments), regardless how acquired, that the taxpayer sells is less than 5 percent of the total basis, immediately after acquisition, of the debt instruments that it acquires in that year.

(3) *Special rules for members of a consolidated group*— (i) *Intragroup-customer election in effect.* If a taxpayer is a member of a consolidated group that has made the intragroup-customer election (described in paragraph (a)(3)(iii) of this section), the negligible sales test in paragraph (c)(2) of this section takes into account all of the taxpayer's sales of debt instruments to other group members.

(ii) *Intragroup-customer election not in effect.* If a taxpayer is a member of a consolidated group that has not made the intragroup-customer election (described in paragraph (a)(3)(iii) of this section), the taxpayer satisfies the negligible sales test in paragraph (c)(2) of this section if either—

(A) The test is satisfied by the taxpayer, taking into account sales of debt instruments to other group members (as in paragraph (c)(3)(i) of this section); or

(B) The test is satisfied by the group, treating the members of the group as if they were divisions of a single corporation.

(4) *Special rules.* Whether sales of securities are negligible is determined without regard to—

(i) Sales of securities that are necessitated by exceptional circumstances and that are not undertaken as recurring business activities;

(ii) Sales of debt instruments that decline in quality while in the taxpayer's hands and that are sold pursuant to an established policy of the taxpayer to dispose of debt instruments below a certain quality; or

(iii) Acquisitions and sales of debt instruments that are qualitatively different from all debt instruments that the taxpayer purchases from customers in the ordinary course of its business.

(5) *Example.* The following example illustrates paragraph (c)(4)(iii) of this section:

Example. I, an insurance company, regularly makes policy loans to its customers but does not sell them. *I,* however, actively trades Treasury securities. No other circumstances are present to suggest that *I* is a dealer in securities for purposes of section 475(c)(1). Since the Treasuries are qualitatively different from the policy loans that *I* originates, under paragraph (c)(4)(iii) of this section, *I* disregards the purchases and sales of Treasuries in applying the negligible sales test in paragraph (c)(2) of this section.

(d) *Issuance of life insurance products.* A life insurance company that is not otherwise a dealer in securities within the meaning of section 475(c)(1) does not become a dealer in securities solely because it regularly issues life insurance products to its customers in the ordinary course of a trade or business. For purposes of the preceding sentence, the term *life insurance product* means a contract that is treated for federal income tax purposes as an annuity, endowment, or life insurance contract. See sections 72, 817, and 7702.

§ 1.475(c)–2 Definitions—security.

(a) *Items that are not securities.* The following items are not securities within the meaning of section 475(c)(2) with respect to a taxpayer and, therefore, are not subject to section 475—

(1) A security (determined without regard to this paragraph (a)) if section 1032 prevents the taxpayer from recognizing gain or loss with respect to that security;

(2) A debt instrument issued by the taxpayer (including a synthetic debt instrument, within the meaning of § 1.1275–6(b)(4), that § 1.1275–6(b) treats the taxpayer as having issued); or

(3) A REMIC residual interest, or an interest or arrangement that is determined by the Commissioner to have substantially the same economic effect, if the residual interest or the interest or arrangement is acquired on or after January 4, 1995.

(b) *Synthetic debt that § 1.1275–6(b) treats the taxpayer as holding.* If § 1.1275–6 treats a taxpayer as the holder of a synthetic debt instrument (within the meaning of § 1.1275–6(b)(4)), the synthetic debt instrument is a security held by the taxpayer within the meaning of section 475(c)(2)(C).

(c) *Negative value REMIC residuals acquired before January 4, 1995.* A REMIC residual interest that is described in paragraph (c)(1) of this section or an interest or arrangement that is determined by the Commissioner to have substantially the same economic effect is not a security within the meaning of section 475(c)(2).

(1) *Description.* A residual interest in a REMIC is described in this paragraph (c)(1) if, on the date the taxpayer acquires the residual interest, the present value of the anticipated tax liabilities associated with holding the interest exceeds the sum of—

(i) The present value of the expected future distributions on the interest; and

(ii) The present value of the anticipated tax savings associated with holding the interest as the REMIC generates losses.

(2) *Special rules applicable to negative value REMIC residuals acquired before January 4, 1995.* Solely for purposes of this paragraph (c)—

(i) If a transferee taxpayer acquires a residual interest with a basis determined by reference to the transferor's basis, then the transferee is deemed to acquire the interest on the date the transferor acquired it (or is deemed to acquire it under this paragraph (c)(2)(i)).

(ii) Anticipated tax liabilities, expected future distributions, and anticipated tax savings are determined under the rules in § 1.860E–2(a)(3) and without regard to the operation of section 475.

(iii) Present values are determined under the rules in § 1.860E–2(a)(4).

§ 1.475(d)–1 Character of gain or loss.

(a) *Securities never held in connection with the taxpayer's activities as a dealer in securities.* If a security is never held in connection with the taxpayer's activities as a dealer in securities, section 475(d)(3)(A) does not affect the character of gain or loss from the security, even if the taxpayer fails to identify the security under section 475(b)(2).

(b) *Ordinary treatment for notional principal contracts and derivatives held by dealers in notional principal contracts and derivatives.* Section 475(d)(3)(B)(ii) (concerning the character of gain or loss with respect to a security held by a person other than in connection with its activities as a dealer in securities) does not apply to a security if § 1.475(b)–1(c) and the absence of a determination by the Commissioner prevent section 475(b)(1)(A) from applying to the security.

§ 1.475(e)–1 Effective dates.

(a) and (b) [Reserved].

(c) Section 1.475(a)–3 (concerning acquisition by a dealer of a security with a substituted basis) applies to securities acquired, originated, or entered into on or after January 4, 1995.

(d) Except as provided elsewhere in this paragraph (d), § 1.475(b)“1 (concerning the scope of exemptions from the mark-to-market requirement) applies to taxable years ending on or after December 31, 1993.

(1) Section 1.475(b)”1(b) applies as follows:

(i) Section 1.475(b)“1(b)(1)(i) (concerning equity interests issued by a related person) applies beginning June 19, 1996. If, on June 18, 1996, a security is subject to mark-to-market accounting and, on June 19, 1996, § 1.475(b)–1(b)(1) begins to apply to the security solely because of the effective dates in this paragraph (d) (rather than because of a change in facts), then the rules of § 1.475(b)–1(b)(4)(i)(A) (concerning the prohibition against marking) apply, but § 1.475(b)–1(b)(4)(i)(B) (imposing a mark to market on the day before the onset of the prohibition) does not apply.

(ii) Section 1.475(b)–1(b)(2) (concerning relevant relationships for purposes of determining whether equity interests in related persons are prohibited from being marked to market) applies beginning June 19, 1996.

(iii) Section 1.475(b)”1(b)(3) (concerning certain actively traded securities) applies beginning June 19, 1996, to securities held on or after that date, except for securities described in § 1.475(b)“1(e)(1)(i) (concerning equity interests issued by controlled entities). If a security is described in § 1.475(b)”1(e)(1)(i), § 1.475(b)-“1(b)(3) applies only on or after January 23, 1997, if the security is held on or after that date. If § 1.475(b)”1(b)(1) ceases to apply to a security by virtue of the operation of this paragraph (d)(1)(iii), the rules of § 1.475(b)“1(b)-(4)(ii) apply to the cessation.

(iv) Except to the extent provided in paragraph (d)(1) of this section, § 1.475(b)”1(b)(4) (concerning changes in status) applies beginning June 19, 1996.

(2) Section 1.475(b)“1(c) (concerning securities deemed not held for investment by dealers in notional principal contracts and derivatives) applies to securities acquired on or after January 23, 1997.

(3) Section 1.475(b)–1(d) (concerning the special rule for hedges of another member's risk) is effective for securities acquired, originated, or entered into on or after January 23, 1997.

(e) Section 1.475(b)–2 (concerning identification of securities that are exempt from mark to market treatment) applies as follows:

(1) Section 1.475(b)–2(a) (concerning the general rules for identification of basis for exemption from mark to market treatment) applies to identifications made on or after July 1, 1997.

(2) Section 1.475(b)–2(b) (concerning time for identifying a security with a substituted basis) applies to securities acquired, originated, or entered into on or after January 4, 1995.

(3) Section 1.475(b)–2(c) (concerning identification in the context of integrated transactions under § 1.1275–6) applies

on and after August 13, 1996 (the effective date of § 1.1275–6).

(f) [Reserved].

(g) Section 1.475(b)–4 (concerning transitional issues relating to exemptions) applies to taxable years ending on or after December 31, 1993.

(h) Section 1.475(c)–1 applies as follows:

(1) Except as otherwise provided in this paragraph (h)(1), § 1.475(c)–1(a) (concerning the dealer-customer relationship) applies to taxable years beginning on or after January 1, 1995.

(i) [Reserved].

(ii) Section 1.475(c)–1(a)(2)(ii) (illustrating rules concerning the dealer-customer relationship) applies to taxable years beginning on or after June 20, 1996.

(iii) (A) Section 1.475(c)–1(a)(3) applies to taxable years beginning on or after June 20, 1996, except for transactions between members of the same consolidated group.

(B) For transactions between members of the same consolidated group, paragraph § 1.475(c)–1(a)(3) applies to taxable years beginning on or after December 24, 1996.

(2) Section 1.475(c)–1(b) (concerning sellers of nonfinancial goods and services) applies to taxable years ending on or after December 31, 1993.

(3) Except as otherwise provided in this paragraph (h)(3), § 1.475(c)–1(c) (concerning taxpayers that purchase securities but engage in no more than negligible sales of the securities) applies to taxable years ending on or after December 31, 1993.

(i) Section 1.475(c)–1(c)(3) (special rules for members of a consolidated group) is effective for taxable years beginning on or after December 24, 1996.

(ii) A taxpayer may rely on the rules set out in § 1.475(c)–1T(b) (as contained in 26 CFR part 1 revised April 1, 1996) for taxable years beginning before January 23, 1997, provided the taxpayer applies that paragraph reasonably and consistently.

(4) Section 1.475(c)–1(d) (concerning the issuance of life insurance products) applies to taxable years beginning on or after January 1, 1995.

(i) Section 1.475(c)–2 (concerning the definition of security) applies to taxable years ending on or after December 31, 1993. By its terms, however, § 1.475(c)–2(a)(3) applies only to residual interests or to interests or arrangements that are acquired on or after January 4, 1995; and the integrated transactions that are referred to in §§ 1.475(c)–2(a)(2) and 1.475(c)–2(b) exist only after August 13, 1996 (the effective date of § 1.1275–6).

(j) Section 1.475(d)–1 (concerning the character of gain or loss) applies to taxable years ending on or after December 31, 1993.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 4. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 5. In § 602.101 paragraph (c) is amended by:

1. Removing the following entry from the table:

§ 602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.475(b)–2T	1545–1422
* * * * *	

2. Adding an entry in numerical order to the table to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.475(b)–4.	1545–1496
* * * * *	

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved December 6, 1996.

Donald C. Lubick,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 23, 1996, 8:45 a.m., and published in the issue of the Federal Register for December 24, 1996, 61 F.R. 67715)

Section 731.—Extent of Recognition of Gain or Loss on Distribution

26 CFR 1.731–2: Partnership distribution of marketable securities.

T.D. 8707

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Distribution of Marketable Securities by a Partnership

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations providing rules for partnership distributions of marketable securities under section 731(c) of the Internal Revenue Code of 1986, as amended, and for determining when those distributions are taxable to the distributee partner. The regulations reflect changes to the law made by the Uruguay Round Agreements Act enacted on December 8, 1994.

DATES: These regulations are effective on December 26, 1996.

FOR FURTHER INFORMATION CONTACT: Terri A. Belanger or William M. Kostak at (202) 622–3080 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document amends 26 CFR part 1 to provide rules relating to the treatment of partnership distributions of marketable securities under section 731(c). Under section 731(a), in the case of a distribution by a partnership to a partner, gain is recognized to the partner only to the extent that any money distributed exceeds the adjusted basis of the partner's interest in the partnership. Prior to the enactment of section 731(c), marketable securities were not considered money and, therefore, the distribution of marketable securities by a partnership to a partner was not a taxable event. Section 731(c) now treats a partnership distribution of marketable securities as a distribution of money and as a taxable event if the value of the distributed securities exceeds the adjusted basis of the partner's interest in the partnership. Section 731(c) also provides several exceptions to the general rule that a distribution of marketable securities will be treated as a distribution of money.

On January 2, 1996, the IRS published in the **Federal Register** (61 FR 28) a notice of proposed rulemaking (PS–2–95) to provide guidance regarding section 731(c). A number of public comments were received concerning the proposed regulations. However, the public hearing scheduled for April 3, 1996, was cancelled because no one requested to speak. After consideration of the written comments received, the proposed regulations are adopted as revised by this Treasury decision.

Explanation of Provisions

I. General background

The proposed regulations provide rules for determining when and the extent to which a distribution of marketable securities by a partnership to a partner will be treated as a distribution of money for purposes of section 731(a). Although modified in response to comments, the final regulations generally adopt the rules contained in the proposed regulations.

II. Public comments

Several comments requested that the IRS reconsider the requirement in § 1.731–2(d)(2)(ii) of the proposed regulations that a marketable security must be actively traded on the date of distribution to qualify for the ''nonrecognition transaction'' exception to section 731(c). Because of this rule, financial instruments (securities) that are treated as marketable securities under section 731(c)(2)(B) on the date of distribution, but that are not actively traded, would not qualify for this exception. Commentators suggested that the final regulations should not include this requirement or should include a more narrowly drafted provision. In response to these comments, the final regulations provide that a security that falls within the definition of marketable security may qualify for the exceptions under § 1.731–2(d) of the final regulations even if the security is not actively traded on the date of distribution. An anti-stuffing rule has been added to address the concern to which the actively-traded requirement of the proposed regulations was directed.

Several comments also suggested that § 1.731–2(d)(2) of the proposed regulations should allow a de minimis amount of cash and marketable securities to be transferred in a nonrecognition transaction. The final regulations provide that if the value of money and marketable securities transferred in a nonrecognition transaction is less than 20 percent of the total amount of all property transferred in exchange for the distributed security, the entire value of the distributed security will qualify for the nonrecognition transaction exception under § 1.731–2(d)(1)(ii) of the final regulations.

Several commentators also suggested that the five-year rules of § 1.731–2(d)(2) and (3) of the proposed regulations be eliminated. Section 1.731–2(d)(2) of the proposed regulations provided that a marketable security that was acquired in a nonrecognition transaction in exchange for other property and distributed within five years by the partnership would not be subject to section 731(c). Section 1.731–2(d)(3) of the proposed regulations provided that a marketable security that was acquired by the partnership before it became actively traded would also not be subject to section 731(c) if it was distributed by the partnership within five years of becoming actively traded. One commentator, for example, argued that a security is no less a substitute for the underlying assets in a nonrecognition transaction after five years than before five years. These five- year rules were included in the proposed regulations because of administrative concerns. For example, it may be difficult, after the passage of many years, for taxpayers or the IRS to determine the circumstances in which a partnership acquired a particular security. Moreover, it is not clear whether certain exceptions should apply to a distribution of securities if those securities were acquired by a partnership many years ago and are now distributed to a partner who was not a partner at the time the securities were acquired. These administrative concerns remain valid, and a five year time limitation provides a reasonable and simple solution to such problems. Therefore, the final regulations retain both five-year rules.

One comment requested clarification regarding whether a section 708(b)(1)(B) termination affects a partnership's qualification for the exceptions under § 1.731–2(d) and (e) of the regulations. Another commentator suggested that the regulations be modified to provide that marketable securities will not be treated as money when there is a deemed distribution of marketable securities by the terminating partnership as the result of a section 708(b)(1)(B) termination. In response to these comments, the final regulations provide that a section 708(b)(1)(B) termination does not have any effect on a partnership's qualification for the exceptions under section 731(c). In addition, a deemed distribution occurring as a result of a section 708(b)(1)(B) termination will not be subject to section 731(c).

Several comments suggested that the 10-percent test in the investment partnership look-through rule under § 1.731–2(e)(4) of the proposed regulations should be modified or eliminated. A partnership can qualify for the investment partnership exception only if it has never been engaged in a trade or business and substantially all of its assets are investment assets. Under the proposed regulations, a partnership is treated as engaged in a trade or business engaged in by, or as holding a proportionate share of the assets of, a lower-tier partnership in which the partnership holds a partnership interest unless the upper-tier partnership does not participate in the management of the lower-tier partnership and the interest held by the upper-tier partnership is less than 10 percent of the total profits and capital interests in the lower-tier partnership. According to the comments, the requirement that the upper-tier partnership not participate in the management of the lower-tier partnership should be sufficient to ensure passive ownership of the interest in the lower-tier partnership. The commentators further argued that ownership of more than 10 percent of the capital and profits interest in a lower-tier partnership may still be consistent with passive ownership. After consideration of these comments, the final regulations modify the rule in the proposed regulations to increase the threshold ownership percentage amount from 10 to 20 percent.

In response to a comment, the final regulations clarify that an interest in a lower-tier partnership that qualifies for the exception to the investment partnership ''look-through'' rule is treated as eligible property for purposes of determining whether the partner who contributed the lower-tier partnership interest is an eligible partner of the upper-tier investment partnership.

One commentator recommended that the regulations include an example that illustrates the section 732(a)(2) ordering rules for distributions that include money, marketable securities and other property, and to clarify whether marketable securities are treated as money for purposes of section 732(a)(2). Because the statute and the regulations provide that marketable securities are treated as money only for purposes of sections 731(a)(1) and 737, no additional examples are necessary.

One comment suggested that the effective date of the regulations should be the same as the effective date of section 731(c) because the regulations contain guidance for the various exceptions provided for by the Internal Revenue Code. In response to this comment, the final regulations provide that, for the period between the effective date of the statutory provision and the effective date of these regulations, taxpayers may apply the rules contained in these regulations. Another comment suggested that the final regulations should make clear that the rules in the investment partnership exception apply with respect to all property contributed to, or held by, a partnership at any time (including any period prior to the enactment of section 731(c)). The IRS and Treasury believe that this is sufficiently clear from the statutory language, and an explicit statement to this effect in these regulations is not necessary and may be confusing.

One comment requested that the regulations provide several examples illustrating abusive transactions intended to be covered by the anti-abuse rules of § 1.731–2(h), and that these rules be coordinated with the general anti-abuse rules of § 1.701–2. After consideration of this comment, it has been determined that the text of the regulations adequately describes several situations that would be considered abusive under these rules, and that additional examples are unnecessary.

In response to several comments, the final regulations clarify that the 90 percent test of § 1.731–2(c)(2)(i) and the 20 percent test of § 1.731–2(c)(2)(ii) are determined using the gross value of the entity's assets, disregarding any debt that may encumber or otherwise be allocable to those assets, other than debt that is incurred to acquire property with a principal purpose of avoiding or reducing the effect of section 731(c).

Finally, the regulations clarify the interaction of the limitation on gain rule in section 731(c)(3)(B) and the various exceptions listed in paragraph (d). The regulations provide that any gain or loss on a distributed security that qualifies for an exception is not taken into account in determining the distributee partner's limitation on gain.

III. Effective dates

In general, section 731(c) applies to distributions made after December 8, 1994. These regulations are effective for distributions made on or after December 26, 1996. However, taxpayers may apply the rules of this section to distributions made after December 8, 1994, and before December 26, 1996.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the notice of proposed rulemaking preceding the regulations was issued prior to March 29, 1996, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are Terri A. Belanger and William M. Kostak, Office of Assistant Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805. * * *

Section 1.731–2 also issued under 26 U.S.C. 731(c). * * *

Par. 2. Section 1.731–2 is added to read as follows:

§ 1.731–2 Partnership distributions of marketable securities.

(a) *Marketable securities treated as money*. Except as otherwise provided in section 731(c) and this section, for purposes of sections 731(a)(1) and 737, the term *money* includes marketable securities and such securities are taken into account at their fair market value as of the date of the distribution.

(b) *Reduction of amount treated as money*—(1) *Aggregation of securities*. For purposes of section 731(c)(3)(B) and this paragraph (b), all marketable securities held by a partnership are treated as marketable securities of the same class and issuer as the distributed security.

(2) *Amount of reduction*. The amount of the distribution of marketable securities that is treated as a distribution of money under section 731(c) and paragraph (a) of this section is reduced (but not below zero) by the excess, if any, of—

(i) The distributee partner's distributive share of the net gain, if any, which would be recognized if all the marketable securities held by the partnership were sold (immediately before the transaction to which the distribution relates) by the partnership for fair market value; over

(ii) The distributee partner's distributive share of the net gain, if any, which is attributable to the marketable securities held by the partnership immediately after the transaction, determined by using the same fair market value as used under paragraph (b)(2)(i) of this section.

(3) *Distributee partner's share of net gain*. For purposes of section 731(c)(3)(B) and paragraph (b)(2) of this section, a partner's distributive share of net gain is determined—

(i) By taking into account any basis adjustments under section 743(b) with respect to that partner;

(ii) Without taking into account any special allocations adopted with a principal purpose of avoiding the effect of section 731(c) and this section; and

(iii) Without taking into account any gain or loss attributable to a distributed security to which paragraph (d)(1) of this section applies.

(c) *Marketable securities*—(1) *In general*. For purposes of section 731(c) and this section, the term *marketable securities* is defined in section 731(c)(2).

(2) *Actively traded*. For purposes of section 731(c) and this section, a financial instrument is actively traded (and thus is a marketable security) if it is of a type that is, as of the date of distribution, actively traded within the meaning of section 1092(d)(1). Thus, for example, if *XYZ* common stock is listed on a national securities exchange, particular shares of *XYZ* common stock that are distributed by a partnership are market-

able securities even if those particular shares cannot be resold by the distributee partner for a designated period of time.

(3) *Interests in an entity*—(i) *Substantially all*. For purposes of section 731(c)(2)(B)(v) and this section, substantially all of the assets of an entity consist (directly or indirectly) of marketable securities, money, or both only if 90 percent or more of the assets of the entity (by value) at the time of the distribution of an interest in the entity consist (directly or indirectly) of marketable securities, money, or both.

(ii) *Less than substantially all*. For purposes of section 731(c)(2)(B)(vi) and this section, an interest in an entity is a marketable security to the extent that the value of the interest is attributable (directly or indirectly) to marketable securities, money, or both, if less than 90 percent but 20 percent or more of the assets of the entity (by value) at the time of the distribution of an interest in the entity consist (directly or indirectly) of marketable securities, money, or both.

(4) *Value of assets*. For purposes of section 731(c) and this section, the value of the assets of an entity is determined without regard to any debt that may encumber or otherwise be allocable to those assets, other than debt that is incurred to acquire an asset with a principal purpose of avoiding or reducing the effect of section 731(c) and this section.

(d) *Exceptions*—(1) *In general*. Except as otherwise provided in paragraph (d)(2) of this section, section 731(c) and this section do not apply to the distribution of a marketable security if—

(i) The security was contributed to the partnership by the distributee partner;

(ii) The security was acquired by the partnership in a nonrecognition transaction, and the following conditions are satisfied—

(A) The value of any marketable securities and money exchanged by the partnership in the nonrecognition transaction is less than 20 percent of the value of all the assets exchanged by the partnership in the nonrecognition transaction; and

(B) The partnership distributed the security within five years of either the date the security was acquired by the partnership or, if later, the date the security became marketable; or

(iii) The security was not a marketable security on the date acquired by the partnership, and the following conditions are satisfied—

(A) The entity that issued the security had no outstanding marketable securities at the time the security was acquired by the partnership;

(B) The security was held by the partnership for at least six months before the date the security became marketable; and

(C) The partnership distributed the security within five years of the date the security became marketable.

(2) *Anti-stuffing rule*. Paragraph (d)(1) of this section does not apply to the extent that 20 percent or more of the value of the distributed security is attributable to marketable securities or money contributed (directly or indirectly) by the partnership to the entity to which the distributed security relates after the security was acquired by the partnership (other than marketable securities contributed by the partnership that were originally contributed to the partnership by the distributee partner). For purposes of this paragraph (d)(2), money contributed by the distributing partnership does not include any money deemed contributed by the partnership as a result of section 752.

(3) *Successor security*. Section 731(c) and this section apply to the distribution of a marketable security acquired by the partnership in a nonrecognition transaction in exchange for a security the distribution of which immediately prior to the exchange would have been excepted under this paragraph (d) only to the extent that section 731(c) and this section otherwise would have applied to the exchanged security.

(e) *Investment partnerships*—(1) *In general*. Section 731(c) and this section do not apply to the distribution of marketable securities by an investment partnership (as defined in section 731(c)(3)(C)(i)) to an eligible partner (as defined in section 731(c)(3)(C)(iii)).

(2) *Eligible partner*—(i) *Contributed services*. For purposes of section 731(c)(3)(C)(iii) and this section, a partner is not treated as a partner other than an eligible partner solely because the partner contributed services to the partnership.

(ii) *Contributed partnership interests*. For purposes of determining whether a partner is an eligible partner under section 731(c)(3)(C), if the partner has contributed to the investment partnership an interest in another partnership that meets the requirements of paragraph (e)(4)(i) of this section after the contribution, the contributed interest is treated as property specified in section 731(c)(3)(C)(i).

(3) *Trade or business activities*. For purposes of section 731(c)(3)(C) and this section, a partnership is not treated as engaged in a trade or business by reason of—

(i) Any activity undertaken as an investor, trader, or dealer in any asset described in section 731(c)(3)(C)(i), including the receipt of commitment fees, break-up fees, guarantee fees, director's fees, or similar fees that are customary in and incidental to any activities of the partnership as an investor, trader, or dealer in such assets;

(ii) Reasonable and customary management services (including the receipt of reasonable and customary fees in exchange for such management services) provided to an investment partnership (within the meaning of section 731(c)(3)(C)(i)) in which the partnership holds a partnership interest; or

(iii) Reasonable and customary services provided by the partnership in assisting the formation, capitalization, expansion, or offering of interests in a corporation (or other entity) in which the partnership holds or acquires a significant equity interest (including the provision of advice or consulting services, bridge loans, guarantees of obligations, or service on a company's board of directors), provided that the anticipated receipt of compensation for the services, if any, does not represent a significant purpose for the partnership's investment in the entity and is incidental to the investment in the entity.

(4) *Partnership tiers*. For purposes of section 731(c)(3)(C)(iv) and this section, a partnership (upper-tier partnership) is not treated as engaged in a trade or business engaged in by, or as holding (instead of a partnership interest) a proportionate share of the assets of, a partnership (lower-tier partnership) in which the partnership holds a partnership interest if—

(i) The upper-tier partnership does not actively and substantially participate in the management of the lower-tier partnership; and

(ii) The interest held by the upper-tier partnership is less than 20 percent of the total profits and capital interests in the lower-tier partnership.

(f) *Basis rules*—(1) *Partner's basis*—(i) *Partner's basis in distributed securities*. The distributee partner's basis in distributed marketable securities with respect to which gain is recognized by reason of section 731(c) and this section is the basis of the security determined under section 732, increased by the amount of such gain. Any increase in the basis of the marketable securities attributable to gain recognized by reason of section 731(c) and this section is allocated to marketable securities in proportion to their respective amounts of unrealized appreciation in the hands of the partner before such increase.

(ii) *Partner's basis in partnership interest*. The basis of the distributee partner's interest in the partnership is determined under section 733 as if no gain were recognized by the partner on the distribution by reason of section 731(c) and this section.

(2) *Basis of partnership property*. No adjustment is made to the basis of partnership property under section 734 as a result of any gain recognized by a partner, or any step-up in the basis in the distributed marketable securities in the hands of the distributee partner, by reason of section 731(c) and this section.

(g) *Coordination with other sections*—(1) *Sections 704(c)(1)(B) and 737*—(i) *In general*. If a distribution results in the application of sections 731(c) and one or both of sections 704(c)(1)(B) and 737, the effect of the distribution is determined by applying section 704(c)(1)(B) first, section 731(c) second, and finally section 737.

(ii) *Section 704(c)(1)(B)*. The basis of the distributee partner's interest in the partnership for purposes of determining the amount of gain, if any, recognized by reason of section 731(c) (and for determining the basis of the marketable securities in the hands of the distributee partner) includes the increase or decrease, if any, in the partner's basis that occurs under section 704(c)(1)(B)(iii) as a result of a distribution to another partner of property contributed by the distributee partner in a distribution that is part of the same distribution as the marketable securities.

(iii) *Section 737*—(A) *Marketable securities as other property*. A distribution of marketable securities is treated as a distribution of property other than money for purposes of section 737 to the extent that the marketable securities are not treated as money under section 731(c). In addition, marketable securities contributed to the partnership are treated as property other than money in determining the contributing partner's net precontribution gain under section 737(b).

(B) *Basis increase under section 737*. The basis of the distributee partner's interest in the partnership for purposes of determining the amount of gain, if any, recognized by reason of section 731(c) (and for determining the basis of the marketable securities in the hands of the distributee partner) does not include the increase, if any, in the partner's basis that occurs under section 737(c)(1) as a result of a distribution of property to the distributee partner in a distribution that is part of the same distribution as the marketable securities.

(2) *Section 708(b)(1)(B)*. If a partnership termination occurs under section 708(b)(1)(B), the successor partnership will be treated as if there had been no termination for purposes of section 731(c) and this section. Accordingly, a section 708(b)(1)(B) termination will not affect whether a partnership qualifies for any of the exceptions in paragraphs (d) and (e) of this section. In addition, a deemed distribution that may occur as a result of a section 708(b)(1)(B) termination will not be subject to section 731(c) and this section.

(h) *Anti-abuse rule*. The provisions of section 731(c) and this section must be applied in a manner consistent with the purpose of section 731(c) and the substance of the transaction. Accordingly, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 731(c) and this section, the Commissioner can recast the transaction for Federal tax purposes as appropriate to achieve tax results that are consistent with the purpose of section 731(c) and this section. Whether a tax result is inconsistent with the purpose of section 731(c) and this section must be determined based on all the facts and circumstances. For example, under the provisions of this paragraph (h)—

(1) A change in partnership allocations or distribution rights with respect to marketable securities may be treated as a distribution of the marketable securities subject to section 731(c) if the change in allocations or distribution rights is, in substance, a distribution of the securities;

(2) A distribution of substantially all of the assets of the partnership other than marketable securities and money to some partners may also be treated as a distribution of marketable securities to the remaining partners if the distribution of the other property and the withdrawal of the other partners is, in substance, equivalent to a distribution of the securities to the remaining partners; and

(3) The distribution of multiple properties to one or more partners at different times may also be treated as part of a single distribution if the distributions are part of a single plan of distribution.

(i) [Reserved]

(j) *Examples*. The following examples illustrate the rules of this section. Unless otherwise specified, all securities held by a partnership are marketable securities within the meaning of section 731(c); the partnership holds no marketable securities other than the securities described in the example; all distributions by the partnership are subject to section 731(a) and are not subject to sections 704(c)(1)(B), 707(a)(2)(B), 751(b), or 737; and no securities are eligible for an exception to section 731(c). The examples read as follows:

Example 1. Recognition of gain. (i) *A* and *B* form partnership *AB* as equal partners. *A* contributes property with a fair market value of $1,000 and an adjusted tax basis of $250. *B* contributes $1,000 cash. *AB* subsequently purchases Security *X* for $500 and immediately distributes the security to *A* in a current distribution. The basis in *A*'s interest in the partnership at the time of distribution is $250.

(ii) The distribution of Security *X* is treated as a distribution of money in an amount equal to the fair market value of Security *X* on the date of distribution ($500). (The amount of the distribution that is treated as money is not reduced under section 731(c)(3)(B) and paragraph (b) of this section because, if Security *X* had been sold immediately before the distribution, there would have been no gain recognized by *AB* and *A*'s distributive share of the gain would therefore have been zero.) As a result, *A* recognizes $250 of gain under section 731(a)(1) on the distribution ($500 distribution of money less $250 adjusted tax basis in *A*'s partnership interest).

Example 2. Reduction in amount treated as money—in general. (i) *A* and *B* form partnership *AB* as equal partners. *AB* subsequently distributes Security *X* to *A* in a current distribution. Immediately before the distribution, *AB* held securities with the following fair market values, adjusted tax bases, and unrecognized gain or loss:

	Value	*Basis*	*Gain (Loss)*
Security *X*	100	70	30
Security *Y*	100	80	20
Security *Z*	100	110	(10)

(ii) If *AB* had sold the securities for fair market value immediately before the distribution to *A*, the partnership would have recognized $40 of net gain ($30 gain on Security *X* plus $20 gain on Security *Y* minus $10 loss on Security *Z*). *A*'s distributive share of this gain would have been $20 (one-half of $40 net gain). If *AB* had sold the remaining securities immediately after the distribution of Security *X* to *A*, the partnership would have $10 of net gain ($20 of gain on Security *Y* minus $10 loss on Security *Z*). *A*'s distributive share of this gain would have been $5 (one-half of $10 net gain). As a result, the distribution resulted in a decrease of $15 in *A*'s distributive share of the net gain in *AB*'s securities ($20 net gain before distribution minus $5 net gain after distribution).

(iii) Under paragraph (b) of this section, the amount of the distribution of Security *X* that is treated as a distribution of money is reduced by $15. The distribution of Security *X* is therefore treated as a distribution of $85 of money to *A* ($100 fair market value of Security *X* minus $15 reduction).

Example 3. Reduction in amount treated as money—carried interest. (i) *A* and *B* form partnership *AB*. *A* contributes $1,000 and provides substantial services to the partnership in exchange for a 60 percent interest in partnership profits. *B* contributes $1,000 in exchange for a 40 percent interest in partnership profits. *AB* subsequently distributes Security *X* to *A* in a current distribution. Immediately before the distribution, *AB* held securities with the following fair market values, adjusted tax bases, and unrecognized gain:

	Value	*Basis*	*Gain*
Security *X*	100	80	20
Security *Y*	100	90	10

(ii) If *AB* had sold the securities for fair market value immediately before the distribution to *A*, the partnership would have recognized $30 of net gain ($20 gain on Security *X* plus $10 gain on Security *Y*). *A*'s distributive share of this gain would have been $18 (60 percent of $30 net gain). If *AB* had sold the remaining securities immediately after the distribution of Security *X* to *A*, the partnership would have $10 of net gain ($10 gain on Security *Y*). *A*'s distributive share of this gain would have been $6 (60 percent of $10 net gain). As a result, the distribution resulted in a decrease of $12 in *A*'s distributive share of the net gain in *AB*'s securities ($18 net gain before distribution minus $6 net gain after distribution).

(iii) Under paragraph (b) of this section, the amount of the distribution of Security *X* that is treated as a distribution of money is reduced by $12. The distribution of Security *X* is therefore treated as a distribution of $88 of money to *A* ($100 fair market value of Security *X* minus $12 reduction).

Example 4. Reduction in amount treated as money—change in partnership allocations. (i) *A* is admitted to partnership *ABC* as a partner with a 1 percent interest in partnership profits. At the time of *A*'s admission, *ABC* held no securities. *ABC* subsequently acquires Security *X*. *A*'s interest in partnership profits is subsequently increased to 2 percent for securities acquired after the increase. *A* retains a 1 percent interest in all securities acquired before the increase. *ABC* then acquires Securities *Y* and *Z* and later distributes Security *X* to *A* in a current distribution. Immediately before the distribution, the securities held by *ABC* had the following fair market values, adjusted tax bases, and unrecognized gain or loss:

	Value	*Basis*	*Gain (Loss)*
Security *X*	1,000	500	500
Security *Y*	1,000	800	200
Security *Z*	1,000	1,100	(100)

(ii) If *ABC* had sold the securities for fair market value immediately before the distribution to *A*, the partnership would have recognized $600 of net gain ($500 gain on Security *X* plus $200 gain on Security *Y* minus $100 loss on Security *Z*). *A*'s distributive share of this gain would have been $7 (1 percent of $500 gain on Security *X* plus 2 percent of $200 gain on Security *Y* minus 2 percent of $100 loss on Security *Z*).

(iii) If *ABC* had sold the remaining securities immediately after the distribution of Security *X* to *A*, the partnership would have $100 of net gain ($200 gain on Security *Y* minus $100 loss on Security *Z*). *A*'s distributive share of this gain would have been $2 (2 percent of $200 gain on Security *Y* minus 2 percent of $100 loss on Security *Z*). As a result, the distribution resulted in a decrease of $5 in *A*'s distributive share of the net gain in *ABC*'s securities ($7 net gain before distribution minus $2 net gain after distribution).

(iv) Under paragraph (b) of this section, the amount of the distribution of Security *X* that is treated as a distribution of money is reduced by $5. The distribution of Security *X* is therefore treated as a distribution of $995 of money to *A* ($1000 fair market value of Security *X* minus $5 reduction).

Example 5. Basis consequences—distribution of marketable security. (i) *A* and *B* form partnership *AB* as equal partners. *A* contributes nondepreciable real property with a fair market value and adjusted tax basis of $100.

(ii) *AB* subsequently distributes Security *X* with a fair market value of $120 and an adjusted tax basis of $90 to *A* in a current distribution. At the time of distribution, the basis in *A*'s interest in the partnership is $100. The amount of the distribution that is treated as money is reduced under section 731(c)(3)(B) and paragraph (b)(2) of this section by $15 (one- half of $30 net gain in Security *X*). As a result, *A* recognizes $5 of gain under section 731(a) on the distribution (excess of $105 distribution of money over $100 adjusted tax basis in *A*'s partnership interest).

(iii) *A*'s adjusted tax basis in Security *X* is $95 ($90 adjusted basis of Security *X* determined under section 732(a)(1) plus $5 of gain recognized by *A* by reason of section 731(c)). The basis in *A*'s interest in the partnership is $10 as determined under section 733 ($100 pre-distribution basis minus $90 basis allocated to Security *X* under section 732).

Example 6. Basis consequences—distribution of marketable security and other property. (i) *A* and *B* form partnership *AB* as equal partners. *A* contributes nondepreciable real property, with a fair market value of $100 and an adjusted tax basis of $10.

(ii) *AB* subsequently distributes Security *X* with a fair market value and adjusted tax basis of $40 to *A* in a current distribution and, as part of the same distribution, *AB* distributes Property *Z* to *A* with an adjusted tax basis and fair market value of $40. At the time of distribution, the basis in *A*'s interest in the partnership is $10. *A* recognizes $30 of gain under section 731(a) on the distribution (excess of $40 distribution of money over $10 adjusted tax basis in *A*'s partnership interest).

(iii) *A*'s adjusted tax basis in Security *X* is $35 ($5 adjusted basis determined under section 732(a)(2) plus $30 of gain recognized by *A* by reason of section 731(c)). *A*'s basis in Property *Z* is $5, as determined under section 732(a)(2). The basis in *A*'s interest in the partnership is $0 as determined under section 733 ($10 pre-distribution basis minus $10 basis allocated between Security *X* and Property *Z* under section 732).

(iv) *AB*'s adjusted tax basis in the remaining partnership assets is unchanged unless the partnership has a section 754 election in effect. If *AB* made such an election, the aggregate basis of *AB*'s assets would be increased by $70 (the difference between the $80 combined basis of Security *X* and Property *Z* in the hands of the partnership before the distribution and the $10 combined basis of the distributed property in the hands of *A* under section 732 after the distribution). Under section 731(c)(5), no adjustment is made to partnership property under section 734 as a result of any gain recognized by *A* by reason of section 731(c) or as a result of any step-up in basis in the distributed marketable securities in the hands of *A* by reason of section 731(c).

Example 7. Coordination with section 737. (i) *A* and *B* form partnership *AB*. *A* contributes Property *A*, nondepreciable real property with a fair market value of $200 and an adjusted basis of $100 in exchange for a 25 percent interest in partnership capital and profits. *AB* owns marketable Security *X*.

(ii) Within five years of the contribution of Property *A*, *AB* subsequently distributes Security *X*, with a fair market value of $120 and an adjusted tax basis of $100, to *A* in a current distribution that is subject to section 737. As part of the same distribution, *AB* distributes Property *Y* to *A* with a fair market value of $20 and an adjusted tax basis of $0. At the time of distribution, there has been no change in the fair market value of Property *A* or the adjusted tax basis in *A*'s interest in the partnership.

(iii) If *AB* had sold Security *X* for fair market value immediately before the distribution to *A*, the partnership would have recognized $20 of gain. *A*'s distributive share of this gain would have been $5 (25 percent of $20 gain). Because *AB* has no other marketable securities, *A*'s distributive share of gain in partnership securities after the distribution would have been $0. As a result, the distribution resulted in a decrease of $5 in *A*'s share of the net gain in *AB*'s securities ($5 net gain before distribution minus $0 net gain after distribution). Under paragraph (b)(2) of this section, the amount of the distribution of Security *X* that is treated as a distribution of money is reduced by $5. The distribution of Security *X* is therefore treated as a distribution of $115 of money to *A* ($120 fair market value of Security *X* minus $5 reduction). The portion of the distribution of the marketable security that is not treated as a distribution of money ($5) is treated as other property for purposes of section 737.

(iv) *A* recognizes total gain of $40 on the distribution. *A* recognizes $15 of gain under section 731(a)(1) on the distribution of the portion of Security *X* treated as money ($115 distribution of money less $100 adjusted tax basis in *A*'s partnership interest). *A* recognizes $25 of gain under section 737 on the distribution of Property *Y* and the portion of Security *X* that is not treated as money. *A*'s section 737 gain is equal to the lesser of (i) *A*'s precontribution gain ($100) or (ii) the excess of the fair market value of property received ($20 fair market value of Property *Y* plus $5 portion of Security *X* not treated as money) over the adjusted basis in *A*'s interest in the partnership immediately before the distribution ($100) reduced (but not below zero) by the amount of money received in the distribution ($115).

(v) *A*'s adjusted tax basis in Security *X* is $115 ($100 basis of Security *X* determined under section 732(a) plus $15 of gain recognized by reason of section 731(c)). *A*'s adjusted tax basis in Property *Y* is $0 under section 732(a). The basis in *A*'s interest in the partnership is $25 ($100 basis before distribution minus $100 basis allocated to Security *X* under section 732(a) plus $25 gain recognized under section 737).

(k) *Effective date*. This section applies to distributions made on or after December 26, 1996. However, taxpayers may apply the rules of this section to distributions made after December 8, 1994, and before December 26, 1996.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved November 27, 1996.

Donald C. Lubick,
Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on December 24, 1996, 8:45 a.m., and published in the issue of the Federal Register for December 26, 1996, 61 F.R. 67936)

Section 1291.—Interest on Tax Deferral

26 CFR 1291–9: Deemed dividend election.

T.D. 8701

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 602

Treatment of Shareholders of Certain Passive Foreign Investment Companies

AGENCY: Internal Revenue Service (IRS), Treasury

ACTION: Final and temporary regulations.

SUMMARY: This document contains final regulations that provide rules for making the deemed sale and deemed dividend elections under section 1291(d)(2). These regulations reflect changes to the law made by the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988, and apply to a shareholder of a passive foreign investment company (PFIC) that elects under section 1295 to treat the PFIC as a qualified electing fund (QEF) for a taxable year after the first taxable year during the shareholder's holding period that the foreign corporation was a PFIC.

DATES: These regulations are effective December 27, 1996.

Applicability: For the specific dates of applicability, see §§ 1.1291–9(k) and 1.1291–10(i).

FOR FURTHER INFORMATION CONTACT: Gayle Novig, (202) 622–3880 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control numbers 1545–1028 and 1545– 1304. All of these paperwork requirements will be consolidated under control number 1545–1507. Responses to these collections of information are mandatory.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The estimated annual burden per respondent varies from .75 hour to 1 hour, depending on individual circumstances, with an estimated average of .76 hour.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service,** Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224, and to the **Office of Management and Budget,** Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to this collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains final regulations to be added to the Income Tax Regulations (26 CFR part 1) under section 1291(d)(2) of the Internal Revenue Code. The final regulations provide rules for making a deemed sale or deemed dividend election to purge a shareholder's holding period of stock of a PFIC of those taxable years during which the PFIC was not a QEF. The Tax Reform Act of 1986 added section 1291(d)(2)(A), relating to the deemed sale election, effective for taxable years of foreign corporations beginning after December 31, 1986. The Technical and Miscellaneous Revenue Act of 1988 amended section 1291(d)(2) to add new section 1291(d)(2)(B), relating to the deemed dividend election, effective for taxable years of foreign corporations beginning after December 31, 1986.

On March 2, 1988, temporary regulations (T.D. 8178 [1988–1 C.B. 313]) relating to the deemed sale election under section 1291(d)(2)(A), in addition to elections under sections 1294, 1295, and 1297, were published in the **Federal Register** (53 FR 6770). A notice of proposed rulemaking (INTL–941–86 [1988–1 C.B. 916]) cross-referencing the temporary regulations was also published in the **Federal Register** for the same day (53 FR 6781).

On April 1, 1992, temporary regulations (T.D. 8404 [1992–1 C.B. 296]) relating to both the deemed sale and deemed dividend elections under section 1291(d)(2)(A) and (B), were published in the **Federal Register** (57 FR 10992). A notice of proposed rulemaking (INTL–941–86; INTL–656–87; INTL–704–87 [1992–1 C.B. 1124]) cross-referencing the temporary regulations was published in the **Federal Register** for the same day (57 FR 11024).

Written comments responding to these notices were received. No public hearing was held for the notice of proposed rulemaking published on March 2, 1988. A public hearing was held November 23, 1992, for the notice of proposed rulemaking published April 1, 1992. After consideration of all the comments, the proposed regulations under section 1291(d)(2) are adopted as revised by this Treasury decision, and the corresponding temporary regulations are removed. Substantive revisions are discussed below. All other revisions are stylistic, and are primarily intended to conform the regulations under § 1.1291–10 to those under § 1.1291–9.

Explanation of Provisions and Revisions and Summary of Comments

1. Introduction

A shareholder of a foreign corporation that qualifies as a PFIC under the income or asset test of section 1296 is subject to the special interest charge regime of section 1291 with respect to certain distributions by the PFIC and dispositions of the stock of the PFIC. Provided the PFIC complies with certain election requirements, a shareholder may elect under section 1295 to treat the PFIC as a QEF. If the election is made, the shareholder is subject to the current inclusion regime of section 1293. If the shareholder makes the section 1295 election for the first year of its holding period for the foreign corporation during which year the foreign corporation is a PFIC, the shareholder is only subject to PFIC taxation under the current inclusion regime. Such a PFIC is a *pedigreed QEF* with respect to the shareholder. However, if the shareholder makes the section 1295 election for a later year, the shareholder is subject to both the interest charge regime of section 1291 and the current inclusion regime of section 1293. Such a PFIC is an *unpedigreed QEF* with respect to the shareholder. To limit its PFIC taxation to the current inclusion regime of section 1293, a shareholder that makes the section 1295 election may also make a section 1291(d)(2) election to purge its holding period of the years, or parts of years, before the effective date of the QEF election during which the foreign corporation was a PFIC (nonQEF years). Thereafter, the PFIC will be treated as a pedigreed QEF with respect to the shareholder.

Section 1291(d)(2) provides two methods to purge the nonQEF years from a shareholder's holding period of PFIC stock. A shareholder may elect under section 1291(d)(2)(A) to be treated as having sold the stock of the PFIC. The gain on the deemed sale is subject to the interest charge regime and therefore taxed as an excess distribution under section 1291. Alternatively, if the PFIC is a controlled foreign corporation (CFC), any U.S. person that is a shareholder of the PFIC may elect under section 1291(d)(2)(B) to be treated as receiving a dividend in the amount of its pro rata share of the post-1986 undistributed earnings and profits of the PFIC. The deemed dividend is taxed to the shareholder as an excess distribution under the interest charge regime. If either election is made, the shareholder's holding period is treated, for purposes of the PFIC rules, as beginning on the date of the deemed sale or dividend (qualification date).

2. Revisions to the Regulations

Section 1.1291–9 provides the rules for making the deemed dividend election under section 1291(d)(2)(B) with respect to a PFIC that is a CFC. Section 1.1291–10 provides the rules for making the deemed sale election under section 1291(d)(2)(A). The final regulations generally follow the proposed regulations with the exceptions described below.

a. Qualification Date

The 1988 temporary regulations under § 1.1291–10T provided that, in general, the date of the deemed sale, referred to as the qualification date, is the first day of the first taxable year of the corporation that it is treated as a QEF under section 1295 (first QEF year). However, the temporary and proposed amendments to § 1.1291–10T published in 1992 changed the qualification date for elections made after May 1, 1992, to the first day of the taxable year for which the shareholder made the QEF election (shareholder's election year). Similarly, under the temporary and proposed § 1.1291–9 regulations, the qualification date is the first day of the shareholder's election year.

Commenters described a potential problem with the designation of the first day of the shareholder's election year as the qualification date where the corporation and the shareholder have different taxable years. In this circumstance, the purging election would not avoid application of the interest charge regime to distributions and dispositions during the period between the first day of the corporation's first QEF year and the first day of the shareholder's election year.

In response to comments, the final regulations adopt the definition of qualification date used in the 1988 temporary regulations for purposes of both the deemed sale and deemed dividend elections made on or after January 27, 1997. For the period after March 31, 1995, to January 26, 1997, the final regulations adopt the definition of qualification date of the 1992 temporary regulations. In addition, the final regulations permit a shareholder that made the deemed sale or deemed dividend election after May 1, 1992 and on or before January 27, 1997, to amend its election and treat the deemed sale or deemed dividend as occurring on the first day of the PFIC's first QEF year, provided the periods of limitations on assessment for the taxable year that includes that date and for the shareholder's election year have not expired.

In response to comments, the final regulations also clarify that if the shareholder's holding period under section 1223 includes the first day of the first QEF year, the shareholder will be treated as holding the stock on that date. Therefore, the shareholder may make a section 1291(d)(2) election for the first QEF year.

b. Elections made with respect to former PFICs

Section 1.1291–9(h) of the proposed regulations provides that a shareholder cannot apply the deemed dividend rules of section 1291(d)(2)(B) to purge PFIC taint, pursuant to section 1297(b)(1), from the stock of a foreign corporation that no longer is a PFIC under either the asset or income test of section 1296(a), but whose stock nevertheless is treated as stock of a PFIC with respect to a shareholder pursuant to section 1297(b)(1) (former PFIC). In addition, the proposed regulations provide that the section 1291(d)(2)(B) election cannot be made with respect to a corporation that will not qualify as a PFIC under section 1296(a)(1) or (2) in the first QEF year.

Several commenters disagreed with the position taken in § 1.1291–9(h) of the proposed regulations. Section 1.1291– 9(i)(1) of the final regulations does not accept these comments and adopts the rule of the proposed regulation denying application of the rules of section 1291(d)(2)(B) for purposes of a section 1297(b)(1) election. In addition, § 1.1291–9(i)(2) modifies the rule of proposed regulation § 1.1291–9(h)(2) to clarify that the section 1295 and 1291(d)(2)(B) elections cannot be made with respect to a former PFIC. Section 1.1291–10(h) of the final regulations adopts a similar rule, clarifying that a shareholder of a former PFIC cannot make the section 1295 and 1291(d)(2)(A) elections. Thus, section 1295 and section 1291(d)(2) elections may only be made with respect to a foreign corporation that is a PFIC by definition under section 1296. Accordingly, the deemed sale election of section 1297(b)(1) remains the only means by which a shareholder may purge a former PFIC of its PFIC taint.

c. Qualification as a CFC

The final regulations, in response to comments, clarify that a shareholder may make the deemed dividend election provided the PFIC qualifies as a CFC for its first QEF year.

d. Time for making the elections

In response to comments, the final regulations clarify the time for making the deemed sale and dividend elections. The regulations provide that if the shareholder and the PFIC have the same taxable year, and therefore the first day of the shareholder's election year and the qualification date are the same, the shareholder may make the election in the same return in which it makes the section 1295 election or in an amended return. The regulations also provide that if the shareholder and the PFIC have different taxable years and therefore the qualification date precedes the first day of the shareholder's election year, the shareholder must make the deemed sale or deemed dividend election in an amended return. If the shareholder is making the section 1291(d)(2) election in an amended return, the amended return must be filed within three years of the due date, as extended under section 6081, for the return for the taxable year that includes the qualification date.

e. Post-1986 accumulated earnings and profits

The proposed regulations provide that the shareholder's old holding period for purposes of the PFIC rules ends on the qualification date, but also provide that its new holding period begins on the qualification date. These rules may have caused confusion concerning the last day of the holding period for purposes of determining post-1986 accumulated earnings and profits. The final regulations revise the holding period rules to provide that the shareholder's holding period ends on the day before the qualification date for purposes of calculating the amount of the deemed dividend.

Special Analyses

It has been determined that this Treasury Decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the notice of proposed rulemaking preceding the regulations was issued prior to March 29, 1996, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. These regulations, which have a retroactive effective date, satisfy the Administrative Procedure Act's requirement in section 553(d) for good cause because they provide necessary guidance for the period after March 31, 1995, and because they are not detrimental to taxpayers. These regulations are necessary because they provide taxpayers with the rules needed to make the elections under section 1291(d)(2). Pursuant to section 7805(f) of the Internal Revenue Code, the notices of proposed rulemaking preceding these regulations were submitted to the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Gayle Novig, Office of the Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entry for section 1.1291–9T and the entry for sections 1.1291–10T, 1.1294–1T, 1.1295–1T, and 1.1297–3T, and by adding entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 ***

Section 1.1291–9 also issued under 26 U.S.C. 1291(d)(2).

Section 1.1291–10 also issued under 26 U.S.C. 1291(d)(2).

Section 1.1294–1T also issued under 26 U.S.C. 1294.

Section 1.1297–3T also issued under 26 U.S.C. 1297(b)(1).***

Par. 2. Section 1.1291–0 is added to read as follows:

§ 1.1291–0 Treatment of shareholders of certain passive foreign investment companies; table of contents.

This section contains a listing of the headings for §§ 1.1291–9 and 1.1291–10.

§ 1.1291–9 Deemed dividend election.

§ 1.1291–10 Deemed sale election.

§ 1.1291–0T [Amended]

Par. 3. Section 1.1291–0T is amended as follows:

1. Remove from the introductory text the language ''1.1291–9T, 1.1291–10T,''.

2. Remove the entries for § 1.1291–9T and § 1.1291–10T from the table.

Par. 4. Section 1.1291–9 is added to read as follows:

§ 1.1291–9 Deemed dividend election.

(a) *Deemed dividend election*—(1) *In general.* This section provides rules for making the election under section 1291(d)(2)(B) (deemed dividend election). Under that section, a shareholder (as defined in paragraph (j)(3) of this section) of a PFIC that is an unpedigreed QEF may elect to include in income as a dividend the shareholder's pro rata share of the post-1986 earnings and profits of the PFIC attributable to the stock held on the qualification date (as defined in paragraph (e) of this section), provided the PFIC is a controlled foreign corporation (CFC) within the meaning of section 957(a) for the taxable year for which the shareholder elects under section 1295 to treat the PFIC as a QEF (section 1295 election). If the shareholder makes the deemed dividend election, the PFIC will become a pedigreed QEF with respect to the shareholder. The deemed dividend is taxed under section 1291 as an excess distribution received on the qualification date. The excess distribution determined under this paragraph (a) is allocated under section 1291(a)(1)(A) only to those days in the shareholder's holding period during which the foreign corporation qualified as a PFIC. For purposes of the preceding sentence, the holding period of the PFIC stock with respect to which the election is made ends on the day before the qualification date. For the definitions of PFIC, QEF, unpedigreed QEF, and pedigreed QEF, see paragraph (j)(1) and (2) of this section.

(2) *Post-1986 earnings and profits defined*—(i) *In general.* For purposes of this section, the term post-1986 earnings and profits means the undistributed earnings and profits, within the meaning of section 902(c)(1), as of the day before the qualification date, that were accumulated and not distributed in taxable years of the PFIC beginning after 1986 and during which it was a PFIC, but without regard to whether the earnings relate to a period during which the PFIC was a CFC.

(ii) *Pro rata share of post-1986 earnings and profits attributable to shareholder's stock*—(A) *In general.* A shareholder's pro rata share of the post-1986 earnings and profits of the PFIC attributable to the stock held by the shareholder on the qualification date is the amount of post-1986 earnings and profits of the PFIC accumulated during any portion of the shareholder's holding period ending at the close of the day before the qualification date and attributable, under the principles of section 1248 and the regulations under that section, to the PFIC stock held on the qualification date.

(B) *Reduction for previously taxed amounts.* A shareholder's pro rata share of the post-1986 earnings and profits of the PFIC does not include any amount that the shareholder demonstrates to the satisfaction of the Commissioner (in the manner provided in paragraph (d)(2) of this section) was, pursuant to another provision of the law, previously included in the income of the shareholder, or of another U.S. person if the shareholder's holding period of the PFIC stock includes the period during which the stock was held by that other U.S. person.

(b) *Who may make the election.* A shareholder of an unpedigreed QEF that is a CFC for the taxable year of the PFIC for which the shareholder makes the section 1295 election may make the deemed dividend election provided the shareholder held stock of that PFIC on the qualification date. A shareholder is treated as holding stock of the PFIC on the qualification date if its holding period with respect to that stock under section 1223 includes the qualification date. A shareholder may make the deemed dividend election without regard to whether the shareholder is a United States shareholder within the meaning of section 951(b). A deemed dividend election may be made by a shareholder whose pro rata share of the post-1986 earnings and profits of the PFIC attributable to the PFIC stock held on the qualification date is zero.

(c) *Time for making the election.* The shareholder makes the deemed dividend election in the shareholder's return for the taxable year that includes the qualification date. If the shareholder and the PFIC have the same taxable year, the shareholder makes the deemed dividend election in either the original return for the taxable year for which the shareholder makes the section 1295 election, or in an amended return for that year. If the shareholder and the PFIC have different taxable years, the deemed dividend election must be made in an amended return for the taxable year that includes the qualification date. If the deemed dividend election is made in an amended return, the amended return must be filed by a date that is within three years of the due date, as extended under section 6081, of the original return for the taxable year that includes the qualification date.

(d) *Manner of making the election*—(1) *In general.* A shareholder makes the deemed dividend election by filing Form 8621 and the attachment to Form 8621 described in paragraph (d)(2) of this section with the return for the taxable year of the shareholder that includes the qualification date, reporting the deemed dividend as an excess distribution pursuant to section 1291(a)(1), and paying the tax and interest due on the excess distribution. A shareholder that makes the deemed dividend election after the due date of the return (determined without regard to extensions) for the taxable year that includes the qualification date must pay additional interest, pursuant to section 6601, on the amount of the underpayment of tax for that year.

(2) *Attachment to Form 8621.* The shareholder must attach a schedule to Form 8621 that demonstrates the calculation of the shareholder's pro rata share of the post-1986 earnings and profits of the PFIC that is treated as distributed to the shareholder on the qualification date pursuant to this section. If the shareholder is claiming an exclusion from its pro rata share of the post-1986 earnings and profits for an amount previously included in its income or the income of another U.S. person, the shareholder must include the following information:

(i) The name, address, and taxpayer identification number of each U.S. person that previously included an amount in income, the amount previously included in income by each such U.S. person, the provision of the law pursuant to which the amount was previously included in income, and the taxable year of inclusion of each amount; and

(ii) A description of the transaction pursuant to which the shareholder acquired, directly or indirectly, the stock of the PFIC from another U.S. person, and the provisions of law pursuant to which the shareholder's holding period includes the period the other U.S. person held the CFC stock.

(e) *Qualification date*—(1) *In general.* Except as otherwise provided in this paragraph (e), the qualification date is the first day of the PFIC's first taxable year as a QEF (first QEF year).

(2) *Elections made after March 31, 1995, and before January 27, 1997*—(i) *In general.* The qualification date for deemed dividend elections made after March 31, 1995, and before January 27, 1997, is the first day of the sharehold-

er's election year. The shareholder's election year is the taxable year of the shareholder for which it made the section 1295 election.

(ii) *Exception.* A shareholder who made the deemed dividend election after May 1, 1992, and before January 27, 1997, may elect to change its qualification date to the first day of the first QEF year, provided the periods of limitations on assessment for the taxable year that includes that date and for the shareholder's election year have not expired. A shareholder changes the qualification date by filing amended returns, with revised Forms 8621 and the attachments described in paragraph (d)(2) of this section, for the shareholder's election year and the shareholder's taxable year that includes the first day of the first QEF year, and making all appropriate adjustments and payments.

(3) *Examples.* The rules of this paragraph (e) are illustrated by the following examples:

Example 1—(i) *Eligibility to make deemed dividend election.* A is a U.S. person who files its income tax return on a calendar year basis. On January 2, 1994, A purchased one percent of the stock of M, a PFIC with a taxable year ending November 30. M was both a CFC and a PFIC, but not a QEF, for all of its taxable years. On December 3, 1996, M made a distribution to its shareholders. A received $100, all of which A reported in its 1996 return as an excess distribution as provided in section 1291(a)(1). A decides to make the section 1295 election in A's 1997 taxable year to treat M as a QEF effective for M's taxable year beginning December 1, 1996. Because A did not make the section 1295 election in 1994, the first year in its holding period of M stock that M qualified as a PFIC, M would be an unpedigreed QEF and A would be subject to both sections 1291 and 1293. A, however, may elect under section 1291(d)(2) to purge the years M was not a QEF from A's holding period. If A makes the section 1291(d)(2) election, the December 3 distribution will not be taxable under section 1291(a). Because M is a CFC, even though A is not a U.S. shareholder within the meaning of section 951(b), A may make the deemed dividend election under section 1291(d)(2)(B).

(ii) *Making the election.* Under paragraph (e)(1) of this section, the qualification date, and therefore the date of the deemed dividend, is December 1, 1996. Accordingly, to make the deemed dividend election, A must file an amended return for 1996, and include the deemed dividend in income in that year. As a result, M will be a pedigreed QEF as of December 1, 1996, and the December 3, 1996, distribution will not be taxable as an excess distribution. Therefore, in its amended return, A may report the December 3, 1996, distribution consistent with section 1293 and the general rules applicable to corporate distributions.

Example 2. X, a U.S. person, owned a five percent interest in the stock of FC, a PFIC with a taxable year ending June 30. X never made the section 1295 election with respect to FC. X transferred her interest in FC to her granddaughter, Y, a U.S. person, on February 14, 1996. The transfer qualified as a gift for federal income tax purposes, and no gain was recognized on the transfer (see Regulation Project INTL–656–87, published in 1992–1 C.B. 1124; see § 601.601(d)(2)(ii)(b) of this chapter). As provided in section 1223(2), Y's holding period includes the period that X held the FC stock. Y decides to make the section 1295 election in her 1996 return to treat FC as a QEF for its taxable year beginning July 1, 1995. However, because Y's holding period includes the period that X held the FC stock, and FC was a PFIC but not a QEF during that period, FC will be an unpedigreed QEF with respect to Y unless Y makes a section 1291(d)(2) election. Although Y did not actually own the stock of FC on the qualification date (July 1, 1995), Y's holding period includes that date. Therefore, provided FC is a CFC for its taxable year beginning July 1, 1995, Y may make a section 1291(d)(2)(B) election to treat FC as a pedigreed QEF.

(f) *Adjustment to basis.* A shareholder that makes the deemed dividend election increases its adjusted basis of the stock of the PFIC owned directly by the shareholder by the amount of the deemed dividend. If the shareholder makes the deemed dividend election with respect to a PFIC of which it is an indirect shareholder, the shareholder's adjusted basis of the stock or other property owned directly by the shareholder, through which ownership of the PFIC is attributed to the shareholder, is increased by the amount of the deemed dividend. In addition, solely for purposes of determining the subsequent treatment under the Code and regulations of a shareholder of the stock of the PFIC, the adjusted basis of the direct owner of the stock of the PFIC is increased by the amount of the deemed dividend.

(g) *Treatment of holding period.* For purposes of applying sections 1291 through 1297 to the shareholder after the deemed dividend, the shareholder's holding period of the stock of the PFIC begins on the qualification date. For other purposes of the Code and regulations, this holding period rule does not apply.

(h) *Coordination with section 959(e).* For purposes of section 959(e), the entire deemed dividend is treated as included in gross income under section 1248(a).

(i) *Election inapplicable to shareholder of former PFIC*—(1) *Coordination with section 1297(b)(1).* The rules of this section do not apply to an election made under section 1297(b)(1).

(2) *Former PFIC.* A shareholder may not make the section 1295 and deemed dividend elections if the foreign corporation is a former PFIC (as defined in paragraph (j)(2)(iv) of this section) with respect to the shareholder. For the rules regarding the election by a shareholder of a former PFIC, see § 1.1297–3T.

(j) *Definitions*—(1) *Passive foreign investment company (PFIC).* A passive foreign investment company (PFIC) is a foreign corporation that satisfies either the income test of section 1296(a)(1) or the asset test of section 1296(a)(2). A corporation will not be treated as a PFIC with respect to a shareholder for those days included in the shareholder's holding period when the shareholder, or a person whose holding period of the stock is included in the shareholder's holding period, was not a United States person within the meaning of section 7701(a)(30).

(2) *Types of PFICs*—(i) *Qualified electing fund (QEF).* A PFIC is a qualified electing fund (QEF) with respect to a shareholder that has elected, under section 1295, to be taxed currently on its share of the PFIC's earnings and profits pursuant to section 1293.

(ii) *Pedigreed QEF.* A PFIC is a pedigreed QEF with respect to a shareholder if the PFIC has been a QEF with respect to the shareholder for all taxable years during which the corporation was a PFIC that are included wholly or partly in the shareholder's holding period of the PFIC stock.

(iii) *Unpedigreed QEF.* A PFIC is an unpedigreed QEF for a taxable year if—

(A) An election under section 1295 is in effect for that year;

(B) The PFIC has been a QEF with respect to the shareholder for at least one, but not all, of the taxable years during which the corporation was a PFIC that are included wholly or partly in the shareholder's holding period of the PFIC stock; and

(C) The shareholder has not made an election under section 1291(d)(2) and this section or § 1.1291–10 with respect to the PFIC to purge the nonQEF years from the shareholder's holding period.

(iv) *Former PFIC.* A foreign corporation is a former PFIC with respect to a shareholder if the corporation satisfies neither the income test of section 1296(a)(1) nor the asset test of section 1296(a)(2), but whose stock, held by that shareholder, is treated as stock of a PFIC, pursuant to section 1297(b)(1), because at any time during the shareholder's holding period of the stock the corporation was a PFIC that was not a QEF.

(3) *Shareholder.* A shareholder is a U.S. person that is a direct or indirect shareholder as defined in Regulation Project INTL–656–87 published in

1992–1 C.B. 1124; see § 601.601(d)(2)(ii)(*b*) of this chapter.

(k) *Effective date.* The rules of this section are applicable as of April 1, 1995.

§ 1.1291–9T [Removed]

Par. 5. Section 1.1291–9T is removed.

Par. 6. Section 1.1291–10 is added to read as follows:

§ 1.1291–10 Deemed sale election.

(a) *Deemed sale election.* This section provides rules for making the election under section 1291(d)(2)(A) (deemed sale election). Under that section, a shareholder (as defined in § 1.1291–9(j)(3)) of a PFIC that is an unpedigreed QEF may elect to recognize gain with respect to the stock of the unpedigreed QEF held on the qualification date (as defined in paragraph (e) of this section). If the shareholder makes the deemed sale election, the PFIC will become a pedigreed QEF with respect to the shareholder. A shareholder that makes the deemed sale election is treated as having sold, for its fair market value, the stock of the PFIC that the shareholder held on the qualification date. The gain recognized on the deemed sale is taxed under section 1291 as an excess distribution received on the qualification date. In the case of an election made by an indirect shareholder, the amount of gain to be recognized and taxed as an excess distribution is the amount of gain that the direct owner of the stock of the PFIC would have realized on an actual sale or other disposition of the stock of the PFIC indirectly owned by the shareholder. Any loss realized on the deemed sale is not recognized. For the definitions of PFIC, QEF, unpedigreed QEF, and pedigreed QEF, see § 1.1291–9(j)(1) and (2).

(b) *Who may make the election.* A shareholder of an unpedigreed QEF may make the deemed sale election provided the shareholder held stock of that PFIC on the qualification date. A shareholder is treated as holding stock of the PFIC on the qualification date if its holding period with respect to that stock under section 1223 includes the qualification date. A deemed sale election may be made by a shareholder that would realize a loss on the deemed sale.

(c) *Time for making the election.* The shareholder makes the deemed sale election in the shareholder's return for the taxable year that includes the qualification date. If the shareholder and the PFIC have the same taxable year, the shareholder makes the deemed sale election in either the original return for the taxable year for which the shareholder makes the section 1295 election, or in an amended return for that year. If the shareholder and the PFIC have different taxable years, the deemed sale election must be made in an amended return for the taxable year that includes the qualification date. If the deemed sale election is made in an amended return, the amended return must be filed by a date that is within three years of the due date, as extended under section 6081, of the original return for the taxable year that includes the qualification date.

(d) *Manner of making the election.* A shareholder makes the deemed sale election by filing Form 8621 with the return for the taxable year of the shareholder that includes the qualification date, reporting the gain as an excess distribution pursuant to section 1291(a), and paying the tax and interest due on the excess distribution. A shareholder that makes the deemed sale election after the due date of the return (determined without regard to extensions) for the taxable year that includes the qualification date must pay additional interest, pursuant to section 6601, on the amount of the underpayment of tax for that year. A shareholder that realizes a loss on the deemed sale reports the loss on Form 8621, but does not recognize the loss.

(e) *Qualification date*—(1) *In general.* Except as otherwise provided in this paragraph (e), the qualification date is the first day of the PFIC's first taxable year as a QEF (first QEF year).

(2) *Elections made after March 31, 1995, and before January 27, 1997*—(i) *In general.* The qualification date for deemed sale elections made after March 31, 1995, and before January 27, 1997, is the first day of the shareholder's election year. The shareholder's election year is the taxable year of the shareholder for which it made the section 1295 election.

(ii) *Exception.* A shareholder who made the deemed sale election after May 1, 1992, and before January 27, 1997, may elect to change its qualification date to the first day of the first QEF year, provided the periods of limitations on assessment for the taxable year that includes that date and for the shareholder's election year have not expired. A shareholder changes the qualification date by filing amended returns, with revised Forms 8621, for the shareholder's election year and the shareholder's taxable year that includes the first day of the first QEF year, and making all appropriate adjustments and payments.

(f) *Adjustments to basis*—(1) *In general.* A shareholder that makes the deemed sale election increases its adjusted basis of the PFIC stock owned directly by the amount of gain recognized on the deemed sale. If the shareholder makes the deemed sale election with respect to a PFIC of which it is an indirect shareholder, the shareholder's adjusted basis of the stock or other property owned directly by the shareholder, through which ownership of the PFIC is attributed to the shareholder, is increased by the amount of gain recognized by the shareholder. In addition, solely for purposes of determining the subsequent treatment under the Code and regulations of a shareholder of the stock of the PFIC, the adjusted basis of the direct owner of the stock of the PFIC is increased by the amount of gain recognized on the deemed sale. A shareholder shall not adjust the basis of any stock with respect to which the shareholder realized a loss on the deemed sale.

(2) *Adjustment of basis for section 1293 inclusion with respect to deemed sale election made after March 31, 1995, and before January 27, 1997.* For purposes of determining the amount of gain recognized with respect to a deemed sale election made after March 31, 1995, and before January 27, 1997, by a shareholder that treats the first day of the shareholder's election year as the qualification date, the adjusted basis of the stock deemed sold includes the shareholder's section 1293(a) inclusion attributable to the period beginning with the first day of the PFIC's first QEF year and ending on the day before the qualification date.

(g) *Treatment of holding period.* For purposes of applying sections 1291 through 1297 to the shareholder after the deemed sale, the shareholder's holding period of the stock of the PFIC begins on the qualification date, without regard to whether the shareholder recognized gain on the deemed sale. For other purposes of the Code and regulations, this holding period rule does not apply.

(h) *Election inapplicable to shareholder of former PFIC.* A shareholder may not make the section 1295 and deemed sale elections if the foreign corporation is a former PFIC (as defined in § 1.1291–9(j)(2)(iv)) with respect to the shareholder. For the rules regarding the election by a shareholder of a former PFIC, see 1.1297–3T.

(i) *Effective date.* The rules of this section are applicable as of April 1, 1995.

§ 1.1291–10T [Removed]

Par. 7. Section 1.1291–10T is removed.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 8. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

§ 602.101 [Amended]

Par. 9. In § 602.101, paragraph (c) is amended by removing the entries for 1.1291–9T and 1.1291–10T from the table and adding entries in numerical order to the table to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.1291–9	1545–1507
1.1291–10	1545–1507
* * * * *	

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved December 12, 1996.

Donald C. Lubick,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 26, 1996, 8:45 a.m., and published in the issue of the Federal Register for December 27, 1996, 61 F.R. 68149)

Section 6231.—Definitions and Special Rules

26 CFR 301.6231(a)(7)–1: Designation or selection of tax matters partner.

T.D. 8698

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 301 and 602

Selection of Tax Matters Partner for Limited Liability Companies

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations giving guidance necessary for the designation or selection of a tax matters partner for partnerships including limited liability companies classified as partnerships.

DATES: These regulations are effective December 23, 1996. For dates of applicability of these regulations, see § 301.6231(a)(7)–2(c).

FOR FURTHER INFORMATION CONTACT: D. Lindsay Russell, (202) 622–3050 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–0790. Responses to these collections of information enable the designation, and the termination of the designation, of a tax matters partner for a partnership.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The estimated annual burden per respondent varies from .50 hour to 1 hour, depending on individual circumstances, with an estimated average of .75 hour.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to this collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

Prior to the enactment of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), adjustments attributable to the tax items of a partnership were made at the partner level. Section 402 of TEFRA added sections 6221 through 6231 to the Internal Revenue Code to allow for consolidated administrative and judicial proceedings to determine the tax treatment of partnership items at the partnership level. Under this consolidated proceeding, the tax matters partner of a partnership represents the partnership before the IRS in all tax matters for a specific taxable year.

Section 6231(a)(7) provides that the tax matters partner of a partnership is the general partner designated as the tax matters partner as provided in regulations or, if no general partner is designated, the general partner having the largest profits interest in the partnership at the close of the taxable year involved (largest-profits-interest rule). Section 6231(a)(7) also provides that, if no general partner is designated and the Commissioner determines that it is impracticable to apply the largest-profits-interest rule, the partner selected by the Commissioner is treated as the tax matters partner.

On April 18, 1986, a notice of proposed rulemaking (LR–205–82) concerning sections 6221 through 6231 and section 6233 was published in the **Federal Register** (51 FR 13231). The notice of proposed rulemaking included guidance concerning designating tax matters partners. Several comments on the proposed regulations were received, but no public hearing was requested and none was held. Temporary regulations identical to the proposed regulations in LR–205–82 were published in the **Federal Register** (52 FR 6779) on March 5, 1987.

On February 29, 1988, the IRS published Rev. Proc. 88–16 (1988–1 C.B. 691). This revenue procedure describes circumstances under which the IRS will determine that it is impracticable to apply the largest-profits-interest rule and describes the criteria the IRS will consider in selecting a tax matters partner for the partnership.

Since the enactment of TEFRA, all states and several foreign jurisdictions have enacted laws providing for the formation of limited liability companies (LLCs). LLCs in most jurisdictions may be classified for Federal tax purposes either as partnerships or associations that are taxable as corporations. For LLCs that are classified as partnerships for Federal tax purposes, it is necessary to determine the tax matters partner for the LLC.

On October 30, 1995, a notice of proposed rulemaking (PS–34–92) concerning section 6231(a)(7) was published in the **Federal Register** (60 FR 55228). The notice of proposed rulemaking amended proposed regulations to consolidate certain guidance necessary to determine the tax matters partner for partnerships. The notice of proposed rulemaking also proposed guidance concerning the designation or selection of a tax matters partner for limited liability companies classified as partnerships. No public hearing was requested or held, and no written comments were received.

Explanation of Provisions

The regulations concerning the designation or selection of tax matters partners proposed by LR–205–82 and PS–34–92 are adopted, with minor stylistic changes, by this Treasury decision. The corresponding temporary regulations are removed.

Effect on Other Documents

Rev. Proc. 88–16 is obsolete as of December 23, 1996.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the notice of proposed rulemaking preceding the regulations was issued prior to March 29, 1996, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply.

Drafting Information

The principal author of these regulations is D. Lindsay Russell, Office of Assistant Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 301 and 602 are amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 is amended by removing the entry for section 301.6231(a)(7)–1T and adding entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 301.6231(a)(7)–1 also issued under 26 U.S.C. 6230 (i) and (k).

Section 301.6231(a)(7)–2 also issued under 26 U.S.C. 6230 (i) and (k). * * *

Par. 2. Section 301.6231(a)(7)–1T is removed.

Par. 3. Section 301.6231(a)(7)–1 is added to read as follows:

§ 301.6231(a)(7)–1 Designation or selection of tax matters partner.

(a) *In general.* A partnership may designate a partner as its tax matters partner for a specific taxable year only as provided in this section. Similarly, the designation of a partner as the tax matters partner for a specific taxable year may be terminated only as provided in this section. If a partnership does not designate a general partner as the tax matters partner for a specific taxable year, or if the designation is terminated without the partnership designating another general partner as the tax matters partner, the tax matters partner is the partner determined under this section.

(b) *Person who may be designated tax matters partner*—(1) *General requirement.* A person may be designated as the tax matters partner of a partnership for a taxable year only if that person—

(i) Was a general partner in the partnership at some time during the taxable year for which the designation is made; or

(ii) Is a general partner in the partnership as of the time the designation is made.

(2) *Limitation on designation of tax matters partner who is not a United States person.* If any United States person would be eligible under paragraph (a) of this section to be designated as the tax matters partner of a partnership for a taxable year, no person who is not a United States person may be designated as the tax matters partner of the partnership for that year without the consent of the Commissioner. For the definition of *United States person*, see section 7701(a)(30).

(c) *Designation of tax matters partner at time partnership return is filed.* The partnership may designate a tax matters partner for a partnership taxable year on the partnership return for that taxable year in accordance with the instructions for that form.

(d) *Certification by current tax matters partner of selection of successor.* If a partner properly designated as the tax matters partner of a partnership for a partnership taxable year under this section certifies that another partner has been selected as the tax matters partner of the partnership for that taxable year, that other partner is thereby designated as the tax matters partner for that year. The current tax matters partner shall make the certification by filing with the service center with which the partnership return is filed a statement that—

(1) Identifies the partnership, the partner filing the statement, and the successor tax matters partner by name, address, and taxpayer identification number;

(2) Specifies the partnership taxable year to which the designation relates;

(3) Declares that the partner filing the statement has been properly designated as the tax matters partner of the partnership for the partnership taxable year and that that designation is in effect immediately before the filing of the statement;

(4) Certifies that the other named partner has been selected as the tax matters partner of the partnership for that taxable year in accordance with the partnership's procedure for making that selection; and

(5) Is signed by the partner filing the statement.

(e) *Designation by general partners with majority interest.* The partnership may designate a tax matters partner for a partnership taxable year at any time after the filing of a partnership return for that taxable year by filing a statement with the service center with which the partnership return was filed. The statement shall—

(1) Identify the partnership and the designated partner by name, address, and taxpayer identification number;

(2) Specify the partnership taxable year to which the designation relates;

(3) Declare that it is a designation of a tax matters partner for the taxable year specified; and

(4) Be signed by persons who were general partners at the close of the year

and were shown on the return for that year to hold more than 50 percent of the aggregate interest in partnership profits held by all general partners as of the close of that taxable year. For purposes of this paragraph (e)(4), all limited partnership interests held by general partners shall be included in determining the aggregate interest in partnership profits held by such general partners.

(f) *Designation by partners with majority interest under certain circumstances*—(1) *In general.* A tax matters partner may be designated for a partnership taxable year under this paragraph (f) only if, at the time the designation is made, each partner who was a general partner at the close of such partnership taxable year is described in one or more of paragraphs (f)(1)(i) through (iv) of this section as follows:

(i) The general partner is dead, or, if the general partner is an entity, has been liquidated or dissolved;

(ii) The general partner has been adjudicated by a court of competent jurisdiction to be no longer capable of managing his or her person or estate;

(iii) The general partner's partnership items have become nonpartnership items under section 6231(b); or

(iv) The general partner is no longer a partner in the partnership.

(2) *Method of making designation.* A tax matters partner for a partnership taxable year may be designated under this paragraph (f) at any time after the filing of the partnership return for such taxable year by filing a written statement with the service center with which the partnership return was filed. The statement shall—

(i) Identify the partnership and the designated tax matters partner by name, address, and taxpayer identification number;

(ii) Specify the partnership taxable year to which the designation relates;

(iii) Declare that it is a designation of a tax matters partner for the partnership taxable year specified; and

(iv) Be signed by persons who were partners at the close of such taxable year and were shown on the return for that year to hold more than 50 percent of the aggregate interest in partnership profits held by all partners as of the close of such taxable year.

(g) *Designation of alternate tax matters partner.* If an individual is designated as the tax matters partner of a partnership under paragraph (c), (d), (e), or (f) of this section, the document by which that individual is designated may also designate an alternate tax matters partner who will become tax matters partner upon the occurrence of one or more of the events described in paragraph (l)(1)(i) or (ii) of this section. The person designated as the alternate tax matters partner becomes the tax matters partner as of the time the designation of the tax matters partner is terminated under paragraph (l)(1)(i) or (ii) of this section. The designation of a person as the alternate tax matters partner shall have no effect in any other case.

(h) *Prior designations superseded.* A designation of a tax matters partner for a partnership taxable year under paragraphs (d), (e), or (f) of this section shall supersede all prior designations of a tax matters partner for that year, including a prior designation of an alternate tax matters partner under paragraph (g) of this section.

(i) *Resignation of designated tax matters partner.* A person designated as the tax matters partner of a partnership under this section may resign at any time by a written statement to that effect. The statement shall specify the partnership taxable year to which the resignation relates and shall identify the partnership and the tax matters partner by name, address, and taxpayer identification number. The statement shall also be signed by the resigning tax matters partner and shall be filed with the service center with which the partnership return was filed.

(j) *Revocation of designation.* The partnership may revoke the designation of the tax matters partner for a partnership taxable year at any time after the filing of a partnership return for that taxable year by filing a statement with the service center with which the partnership return was filed. The statement shall—

(1) Identify by name, address, and taxpayer identification number the partnership and the general partner whose designation as tax matters partner is being revoked;

(2) Specify the partnership taxable year to which the revocation relates;

(3) Declare that it is a revocation of a designation of the tax matters partner for the taxable year specified; and

(4) Be signed by the persons described in paragraph (e)(4) of this section, or, if at the time that the revocation is made, each partner who was a general partner at the close of the partnership taxable year to which the revocation relates is described in one or more of paragraphs (f)(1)(i) through (iv) of this section, by the persons described in paragraph (f)(2)(iv) of this section.

(k) *When designation, etc., becomes effective*—(1) *In general.* Except as otherwise provided in paragraph (k)(2) of this section, a designation, resignation, or revocation provided for in this section becomes effective on the day that the statement required by the applicable paragraph of this section is filed.

(2) *Notice of proceeding mailed.* If a notice of beginning of an administrative proceeding with respect to a partnership taxable year is mailed before the date on which a statement of designation, resignation, or revocation provided for in this section with respect to that taxable year is filed, the Service is not required to give effect to such designation, resignation, or revocation until 30 days after the statement is filed.

(l) *Termination of designation*—(1) *In general.* A designation of a tax matters partner for a taxable year under this section shall remain in effect until—

(i) The death of the designated tax matters partner;

(ii) An adjudication by a court of competent jurisdiction that the individual designated as the tax matters partner is no longer capable of managing the individual's person or estate;

(iii) The liquidation or dissolution of the tax matters partner, if the tax matters partner is an entity;

(iv) The partnership items of the tax matters partner become nonpartnership items under section 6231(c) (relating to special enforcement areas); or

(v) The day on which—

(A) The resignation of the tax matters partner under paragraph (i) of this section;

(B) A subsequent designation under paragraph (d), (e), or (f) of this section; or

(C) A revocation of the designation under paragraph (j) of this section becomes effective.

(2) *Actions by the tax matters partner before termination of designation.* The termination of the designation of a partner as the tax matters partner under paragraph (l)(1) of this section does not affect the validity of any action taken by that partner as tax matters partner before the designation is terminated. For example, if that tax matters partner had previously consented to an extension of the period for assessments under section 6229(b)(1)(B), that extension remains valid even after termination of the designation.

(m) *Tax matters partner where no partnership designation made*—(1) *In general.* The tax matters partner for a partnership taxable year shall be determined under this paragraph (m) if—

(i) The partnership has not designated a tax matters partner under this section for that taxable year; or

(ii) The partnership has designated a tax matters partner under this section for that taxable year, that designation has been terminated under paragraph (l)(1) of this section, and the partnership has not made a subsequent designation under this section for that taxable year.

(2) *General partner having the largest profits interest is the tax matters partner.* The tax matters partner for any partnership taxable year to which this paragraph (m) applies is the general partner having the largest profits interest in the partnership at the close of that taxable year (or where there is more than one such partner, the one of such partners whose name would appear first in an alphabetical listing). For purposes of this paragraph (m)(2), all limited partnership interests held by a general partner shall be included in determining that general partner's profits interest in the partnership. For purposes of this paragraph (m)(2), the general partner with the largest profits interest is determined based on the year-end profits interests reported on the Schedules K–1 filed with the partnership income tax return for the taxable year for which the determination is being made.

(3) *Termination of designation.* A designation of a tax matters partner for a partnership taxable year under this paragraph (m) shall remain in effect until the earlier of the occurrence of one or more of the events described in paragraphs (l)(1)(i) through (iv) of this section or the day on which a designation under paragraph (d), (e), or (f) of this section becomes effective. If a designation of a tax matters partner for a partnership taxable year is terminated under this paragraph (m)(3) and the partnership has not subsequently designated a tax matters partner for that taxable year under paragraph (d), (e), or (f) of this section, the tax matters partner for that taxable year shall be determined under paragraph (m)(2) of this section, and, for purposes of applying paragraph (m)(2) of this section, the general partner whose designation was so terminated shall be treated as having no profits interest in the partnership for that taxable year.

(n) *Selection of tax matters partner by Commissioner when impracticable to apply the largest-profits-interest rule.* If the partnership has not designated a tax matters partner under this section for the taxable year and it is impracticable (as determined under paragraph (o) of this section) to apply the largest-profits-interest rule of paragraph (m)(2) of this section, the Commissioner will select a tax matters partner as described in paragraph (p) of this section.

(o) *Impracticability of largest-profits-interest rule.* It is impracticable to apply the largest-profits-interest rule of paragraph (m)(2) of this section if, on the date the rule is applied, any one of the following three conditions is met:

(1) *General partner with the largest profits interest is not apparent.* The general partner with the largest profits interest is not apparent from the Schedules K–1 and is not otherwise readily determinable.

(2) *Each general partner is deemed to have no profits interest in the partnership.* Each general partner is deemed to have no profits interest in the partnership under paragraph (m)(3) of this section (concerning termination of a designation under the largest-profits-interest rule) because of the occurrence of one or more of the events described in paragraphs (l)(1)(i) through (iv) of this section (involving death, adjudication of incompetency, liquidation, and conversion of partnership items to nonpartnership items).

(3) *General partner with the largest profits interest is disqualified.* The general partner with the largest profits interest determined under paragraph (m)(2) of this section—

(i) Has been notified of suspension from practice before the Internal Revenue Service;

(ii) Is incarcerated;

(iii) Is residing outside the United States, its possessions, or territories; or

(iv) Cannot be located or cannot perform the functions of a tax matters partner for any reason, except that lack of cooperation with the Internal Revenue Service by the general partner with the largest profits interest is not a basis for finding that the partner cannot perform the functions of a tax matters partner.

(p) *Commissioner's selection of the tax matters partner*—(1) *When the general partner with the largest profits interest is not apparent.* If it is impracticable under paragraph (o)(1) of this section to apply the largest-profits-interest rule of paragraph (m)(2) of this section, the Commissioner will select (in accordance with the notification procedures set forth in paragraph (r) of this section) as the tax matters partner any person who was a general partner at any time during the taxable year under examination.

(2) *When each general partner is deemed to have no profits interest in the partnership.* If it is impracticable under paragraph (o)(2) of this section to apply the largest-profits-interest rule of paragraph (m)(2) of this section, the Commissioner will select a partner (including a general or limited partner) as the tax matters partner in accordance with the criteria set forth in paragraph (q) of this section. The Commissioner will notify both the partner selected and the partnership of the selection, effective as of the date specified in the notice.

(3) *When the general partner with the largest profits interest is disqualified*—(i) *In general.* Except as otherwise provided in paragraph (p)(3)(ii) of this section, if it is impracticable under paragraph (o)(3) of this section to apply the largest-profits-interest rule of paragraph (m)(2) of this section, the Commissioner will treat each general partner who fits the criteria contained in paragraph (o)(3) of this section as having no profits interest in the partnership for the taxable year and will select (in accordance with the notification procedures set forth in paragraph (r) of this section) a tax matters partner from the remaining persons who were general partners at any time during the taxable year.

(ii) *Partner selected if no general partner may be selected.* If all general partners during the taxable year either are treated as having no profits interest in the partnership for the taxable year under paragraph (m)(3) of this section (concerning termination of a designation under the largest-profits-interest rule) or are described in paragraph (o)(3) of this section (general partner with the largest profits interest is disqualified), the Commissioner will select a partner (including a general or limited partner) as the tax matters partner in accordance with the criteria set forth in paragraph (q) of this section. The Commissioner will notify both the partner selected and the partnership of the selection, effective as of the date specified in the notice.

(q) *Criteria for selecting a partner as tax matters partner*—(1) *In general.* The Commissioner will select a partner as the tax matters partner under paragraph (p)(2) or (3)(ii) of this section only if the partner was a partner in the partnership at the close of the taxable year under examination.

(2) *Criteria to be considered.* The Commissioner may consider the following criteria in selecting a partner as the tax matters partner:

(i) The general knowledge of the partner in tax matters and the administrative operation of the partnership.

(ii) The partner's access to the books and records of the partnership.

(iii) The profits interest held by the partner.

(iv) The views of the partners having a majority interest in the partnership regarding the selection.

(v) Whether the partner is a partner of the partnership at the time the tax-matters-partner selection is made.

(vi) Whether the partner is a United States person (within the meaning of section 7701(a)(30)).

(3) *Limited restriction on subsequent designation of a tax matters partner by the partnership.* For purposes of paragraphs (p)(2) and (3)(ii) of this section, the partnership cannot designate a partner who is not a general partner to serve as tax matters partner in lieu of a partner selected by the Commissioner.

(r) *Notification of partnership*—(1) *In general.* If the Commissioner selects a tax matters partner under the provisions of paragraph (p)(1) or (3)(i) of this section, the Commissioner will notify both the partner selected and the partnership of the selection, effective as of the date specified in the notice.

(2) *Limited opportunity for partnership to designate the tax matters partner.* (i) Before the Commissioner selects a tax matters partner under paragraphs (p)(1) and (3)(i) of this section, the Commissioner will notify the partnership by mail that, after 30 days from the date of the notice, the Commissioner will make a determination that it is impracticable to apply the largest-profits-interest rule of paragraph (m)(2) of this section and will select the tax matters partner unless a prior designation is made by the partnership. This delay in making the determination will permit the partnership to designate a tax matters partner under paragraph (e) of this section (designation by general partners with a majority interest) or paragraph (f) of this section (designation by partners with a majority interest under certain circumstances), thereby avoiding a selection made by the Commissioner.

(ii) During the 30-day period and prior to a tax-matters-partner designation by the partnership, the Commissioner will communicate with the partnership by sending all correspondence or notices to "The Tax Matters Partner" in care of the partnership at the partnership's address.

(iii) Any subsequent designation of a tax matters partner by the partnership after the 30-day period will become effective as provided under paragraph (k)(2) of this section (concerning designations made after a notice of beginning of administrative proceeding is mailed).

(s) *Effective date.* This section applies to all designations, selections, and terminations of a tax matters partner occurring on or after December 23, 1996.

Par. 4. Section 301.6231(a)(7)–2 is added to read as follows:

§ 301.6231(a)(7)–2 Designation or selection of tax matters partner for a limited liability company (LLC).

(a) *In general.* Solely for purposes of applying section 6231(a)(7) and § 301.6231(a)(7)–1 to an LLC, only a member-manager of an LLC is treated as a general partner, and a member of an LLC who is not a member-manager is treated as a partner other than a general partner.

(b) *Definitions*—(1) *LLC.* Solely for purposes of this section, LLC means an organization—

(i) Formed under a law that allows the limitation of the liability of all members for the organization's debts and other obligations within the meaning of § 301.7701–3(b)(2)(ii); and

(ii) Classified as a partnership for Federal tax purposes.

(2) *Member.* Solely for purposes of this section, *member* means any person who owns an interest in an LLC.

(3) *Member-manager.* Solely for purposes of this section, *member-manager* means a member of an LLC who, alone or together with others, is vested with the continuing exclusive authority to make the management decisions necessary to conduct the business for which the organization was formed. Generally, an LLC statute may permit the LLC to choose management by one or more managers (whether or not members) or by all of the members. If there are no elected or designated member-managers (as so defined in this paragraph (b)(3)) of the LLC, each member will be treated as a member-manager for purposes of this section.

(c) *Effective date.* This section applies to all designations, selections, and terminations of a tax matters partner of an LLC occurring on or after December 23, 1996. Any other reasonable designation or selection of a tax matters partner of an LLC is binding for periods prior to December 23, 1996.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 5. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 6. In § 602.101, paragraph (c) is amended by adding the entry "301.6231(a)(7)–1....1545–0790" in numerical order to the table.

Michael P. Dolan,
Acting Commissioner of Internal Revenue.

Approved November 8, 1996.

Donald C. Lubick,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 20, 1996, 8:45 a.m., and published in the issue of the Federal Register for December 23, 1996, 61 F.R. 67454)

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Qualified Electing Fund Elections

REG–209040–88

AGENCY: Internal Revenue Service (IRS), Treasury

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations permitting certain shareholders to make a special election under section 1295, in lieu of the election currently provided for under that section, with respect to certain preferred shares of a passive foreign investment company (PFIC). A shareholder that makes a special election must account for dividend income on the shares subject to the special election under special income inclusion rules, rather than under the general income inclusion rules of section 1293. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments must be received by March 24, 1997. Requests to speak and outlines of oral comments to be discussed at the public hearing scheduled for May 8, 1997, at 10:00 a.m. must be received by April 17, 1997.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–209040–88), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R REG–209040–88), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in room 3313, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Judith Cavell Cohen, (202) 622–3880; concerning submissions and the hearing, Evangelista Lee, (202) 622–7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224. Comments on the collection of information should be received by February 24, 1997. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information in this proposed regulation is in proposed regulation § 1.1295–2(c)(3) and proposed regulation § 1.1295–2(e) and (f). This information will notify the Commissioner that certain shareholders have made the special election. In addition, this information will enable the IRS to determine if a shareholder qualifies for the special election and is satisfying the income inclusion requirements of proposed regulation § 1.1293–2. The collection of information is mandatory. The likely respondents are individuals, businesses, and other for-profit organizations.

Estimated total annual reporting/recordkeeping burden: 600 hours. The estimated annual burden per respondent varies from 21 minutes to 8.3 hours, depending on individual circumstances, with an estimated average of 35 minutes.

Estimated number of respondents: 1030.

Estimated annual frequency of responses: On occasion.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains proposed Income Tax Regulations (26 CFR part 1) under sections 1293 and 1295 of the Internal Revenue Code. Sections 1293 and 1295 were added by the Tax Reform Act of 1986 (the Act) and were amended by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA). The sections, as amended, were effective for taxable years of foreign corporations beginning after December 31, 1986. Section 1293 also was amended by the Omnibus Reconciliation Act of 1993 (OBRA). Guidance for making the section 1295 election was provided in proposed regulation § 1.1295–1 and Notice 88–125, 1988–2 C.B. 535. Guidance regarding the annual income inclusion rule for shareholders making a section 1295 election was provided in proposed regulation § 1.1293–1.

Explanation of Provisions

Special Preferred Section 1295 Election

1. Introduction

The passive foreign investment company (PFIC) rules of the Code are designed to eliminate potential tax deferral opportunities associated with equity investments by United States persons in foreign corporations that have substantial levels of passive income or assets. The PFIC rules eliminate tax deferral opportunities by applying the section 1291 interest charge regime to PFIC shareholders that fail to make a section 1295 annual income inclusion election (section 1295 election). In general, the section 1291 interest charge regime applies to the "extraordinary" portion of any distribution received by the shareholder, and any gain recognized on a disposition of shares.

The PFIC rules apply to investments in both common and preferred shares of a PFIC. Preferred shares, unlike common shares, generally provide for limited dividend and liquidation or redemption rights, and thus do not participate significantly in corporate growth. Accordingly, preferred shares of a PFIC generally do not afford U.S. investors with the same potential for U.S. tax deferral as common shares of a PFIC.

Preferred shareholders, like common shareholders, may make the section 1295 election to avoid the interest charge regime of section 1291. Shareholders that make the section 1295 election are required under section 1293 to include in income annually, as ordinary income, their pro rata share of the PFIC's ordinary earnings and, as long-term capital gain, their pro rata share of the PFIC's net capital gain for the year. In order to determine their pro rata share of ordinary earnings and net capital gain, shareholders that have made a section 1295 election must obtain certain U.S. tax accounting information from the PFIC regarding the PFIC's earnings. If this information is not available, the shareholders cannot make the section 1295 election. If the requisite information is available, the annual information reporting and collection requirements associated with the section 1295 election may render the election impractical for smaller investors. Because preferred shares often do not afford investors with significant tax-deferral opportunity, commenters have suggested that the current section 1295 election regime should be simplified for certain types of preferred shares.

The proposed regulations adopt a special section 1295 election regime that would require holders of certain preferred shares of a PFIC that elect to be subject to the regime to accrue annually ordinary dividend income with respect to the preferred shares regardless of the holder's pro rata share of ordinary earnings or net capital gain of the PFIC for the year. Because shareholders would accrue income regardless of the earnings and net capital gain of the PFIC, shareholders that elect to be subject to the regime would not have to report and collect any U.S. tax accounting information regarding the PFIC in order to make the special section 1295 election.

The proposed regulations are issued under two sections of the Code. Section 1.1295–2 of the proposed regulations provides rules for making a QEF election under the special proposed section 1295 election regime (special preferred QEF election). Section 1.1293–2 describes the annual income inclusion rules for shareholders that have made the special preferred QEF election.

The proposed regulations would apply only with respect to qualifying preferred shares issued after the date the proposed regulations are finalized.

2. Rules for making the special preferred QEF election

Under proposed regulation § 1.1295–2(a), the special preferred QEF election may be made in lieu of the section 1295 election described in proposed regulation § 1.1295–1 and Notice 88–125, 1988–2 C.B. 535 (regular section 1295 election), with respect to certain types of preferred shares (qualified preferred shares) by certain holders satisfying prescribed ownership requirements.

The special preferred QEF election may only be made with respect to qualified preferred shares as defined in proposed regulation § 1.1295–2(b). To ensure that the special preferred QEF election cannot be used for tax avoidance purposes and to reduce complexity, the proposed regulations define qualified preferred shares narrowly to include only a limited class of preferred shares likely to be marketed to U.S. retail investors. Although the definition of qualified preferred shares includes both cumulative and non-cumulative preferred shares, the definition excludes various types of preferred shares, including preferred shares denominated in a foreign currency and preferred shares issued at a significant discount to their liquidation or redemption amounts. The PFIC issuing the preferred shares must represent that it intends to pay dividends currently. Proposed regulation § 1.1295–2(b) provides additional restrictions with respect to preferred shares acquired in secondary market transactions.

Proposed regulation § 1.1295–2(c) describes shareholders who may make the election. Under proposed regulation § 1.1295–2(c)(1), any United States person that acquires qualified preferred shares for cash or in certain nonrecognition transactions and that holds such shares directly may make the election. United States persons that are pass-through entities, including partnerships, S corporations, trusts and estates, may qualify as shareholders.

The special preferred QEF election regime is narrowly targeted to eliminate certain of the information reporting and collection requirements associated with the existing section 1295 election and annual inclusion rules for U.S. retail investors in preferred shares of PFICs. Treasury and the Service believe that the special preferred QEF election regime should only apply with respect to foreign corporations that are not expected to be in a position to provide U.S. tax accounting information to shareholders. Accordingly, proposed regulation § 1.1295–2(c)(2) provides that the special preferred QEF election does not apply to holders of preferred shares in a PFIC that is a controlled foreign corporation. Further, proposed regulation § 1.1295–2(c)(3) provides that the special preferred QEF election does not apply to holders that own 5 percent or more of the vote or value of any class of shares of the PFIC. Holders of five percent or more of the vote or value of any class of shares generally are not the type of retail investor that the proposed regulations are designed to assist. Such holders may only make the section 1295 election provided under current rules.

Proposed regulation § 1.1295–2(c)(3) requires the corporation to provide to electing shareholders a statement, directly or in a disclosure document generally available to all U.S. shareholders, either that it is or that it reasonably believes that it is a PFIC and that it is not a controlled foreign corporation. Shareholders that fail to receive such a statement are not permitted to make a special preferred QEF election

Proposed regulation § 1.1295–2(d) describes the effect of the special preferred QEF election. Proposed regulation § 1.1295–2(d)(1) provides that shares subject to a special preferred QEF election will be treated as shares of a pedigreed QEF (as defined in proposed regulation § 1.1291–1(b)(2)(ii)) for all taxable years of the foreign corporation that are included wholly or partly in the shareholder's holding period of the shares. Under the proposed regulations, the election will apply to all qualified preferred shares of a foreign corporation owned directly by the shareholder that are acquired in the taxable year with respect to which the election is made. Although a special preferred QEF election will not apply automatically to qualified preferred shares acquired in subsequent taxable years of a shareholder, the proposed regulations permit the shareholder to make separate special preferred QEF elections with respect to qualified preferred shares acquired in later years.

Proposed regulation § 1.1295–2(d)(2) provides that the special preferred QEF election regime applies whether or not the foreign corporation is a PFIC in any year subsequent to the year of the election. Accordingly, shareholders that make the special preferred QEF election must make annual § 1.1293–2 income inclusions, as provided in proposed regulation § 1.1295–2(d)(3), even if the foreign corporation does not qualify as a PFIC for a particular year.

Proposed regulation § 1.1295–2(e) specifies the time and manner of making the special preferred QEF election. In order to make the special preferred QEF election, a shareholder files Form 8621 (Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund), for the taxable year of the election, checking the appropriate box in Form 8621, Part I, for making the section 1295 election, and indicating in the margin of Part I that the shareholder is making a special preferred QEF election with respect to certain specified shares. In addition, the shareholder must attach to Form 8621 a brief statement containing the information and representations contained in proposed regulation § 1.1295–2(e)(2)(ii). Under proposed regulation § 1.1295–2(f), in subsequent years, the shareholder must file Form 8621 with respect to the foreign corporation but need not attach any statement to the form. For all taxable years covered by the election, the shareholder must report on Line 6a of Part II of Form 8621 the amount includible under proposed regulation § 1.1293–2 with respect to qualified preferred shares subject to a special preferred QEF election.

Proposed regulation § 1.1293–2(g) states that a sale, exchange or other disposition of shares subject to a special preferred QEF election terminates the election with respect to those shares. Also, the Commissioner may terminate or invalidate an election if a shareholder fails to satisfy the initial or ongoing requirements of the election. For example, the Commissioner may terminate or invalidate a special preferred QEF election if the shareholder owns five percent or more of the vote or value of any class of shares of the PFIC at any time during the period that the shareholder owns qualified preferred shares subject to the election. A shareholder may not itself terminate a special preferred QEF election.

3. Annual inclusion rules for electing shareholders

Under proposed regulation § 1.1293–2(a), a shareholder that has made a special preferred QEF election must make annual income inclusions with respect to qualified preferred shares subject to the election. Unlike the annual income inclusions provided under section 1293 and proposed regulation § 1.1293–1, the annual inclusions under the special preferred QEF election regime are determined without regard to the shareholder's pro rata share of the foreign corporation's ordinary earnings or net capital gains.

Proposed regulation § 1.1293–2(b) provides rules for determining the amount that a shareholder must include in income annually under the special preferred QEF election regime. Under the proposed regulations, this annual amount consists of two components. The first component is an annual inclusion amount based on a ratable daily portion of dividend income that accrues on the qualified preferred shares (annual dividend amount). This ratable inclusion rule for the annual dividend amount is analogous to the rule for inclusion of income with respect to periodic payments on notional principal contracts under § 1.446–3. The second component of the preferred QEF amount arises only in respect of fixed term preferred shares, as described proposed regulation § 1.1295–2(b)(vii), acquired in a secondary market transaction, and is calculated based on the ratable inclusion of the excess, if any, of the redemption price of the shares over the acquisition cost of the shares (preferred discount amount). This ratable inclusion rule for the preferred discount amount is analogous to the rule for the ratable inclusion of market discount on certain debt under section 1276(b)(1). The Service and Treasury solicit comments regarding the income inclusion rules of the proposed regulations, including comments as to whether foreign corporations and their agents could effectively assist holders in complying with the income inclusion rules applicable to preferred discount.

Proposed regulation § 1.1293–2(c) provides certain special rules regarding the annual income inclusion required under proposed regulation § 1.1293–2(a). Under § 1.1293–2(c)(1), annual amounts are included in income by shareholders irrespective of the PFIC's earnings and profits. In this regard, the special preferred QEF election differs from the regular section 1295 election in that shareholders making the special preferred QEF election must accrue the annual amount as ordinary income even if the amount exceeds the shareholder's pro rata share of the foreign corporation's earnings and profits. Proposed regulation § 1.1293–2(c)(3) requires the shareholder to include the annual dividend amount as ordinary income regardless of whether any portion of the PFIC's earnings for the year represents net capital gain. Proposed regulation § 1.1293–2(c)(4) provides rules for the tax-free distribution of previously taxed amounts. Proposed regulation § 1.1293–2(c)(5) provides certain basis adjustment rules similar to the basis adjustment rule of section 1293(d). Finally, proposed regulation § 1.1293–2(c)(6) provides rules intended to limit the effect of a special preferred QEF election to the shareholder making the election. Accordingly, a special preferred QEF election will not affect the foreign corporation's calculation of its earnings and profits, and will have no consequences for shareholders that have not made a special preferred QEF election.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations do not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations represent a wholly elective simpler alternative to the section 1295 election described in § 1.1295–1 and Notice 88–125, 1988–2 C.B. 535, and impose a lighter collection of information burden. Further, the requirement that electing shareholders indicate their special election on Form 8621 annually and attach a statement, providing certain information in the first year of the election only, is minimal and will not impose a significant economic impact on electing shareholders. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the

Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for May 8, 1997, at 10:00 a.m. in room 3313, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by March 24, 1997, and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by April 17, 1997.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the schedule of speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Judith Cavell Cohen of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.1293–2 also issued under 26 U.S.C. 1297(f).

Section 1.1295–2 also issued under 26 U.S.C. 1297(f). * * *

Par. 2. Section 1.1293–2 is added to read as follows:

§ 1.1293–2 Special Inclusion Rules for Special Preferred QEF Election

(a) *In general.* A shareholder (including a shareholder that is a pass-through entity, as described in § 1.1295–2(c)(1)) that makes a special preferred QEF election under § 1.1295–2 must, regardless of the shareholder's method of accounting, include in income in respect of each share subject to the election, an annual amount (preferred QEF amount) determined according to the rules of paragraph (b) of this section. A shareholder that makes a special preferred QEF election must include the preferred QEF amount in income under this section for each year in which the taxpayer continues to hold a share that is subject to the election. The rules of this section apply in lieu of the general rules of section 1293 and § 1.1293–1.[1]

(b) *Preferred QEF amount*—(1) *In general.* The preferred QEF amount for any share subject to a special preferred QEF election is the sum of the ratable daily portion of each periodic dividend amount (as described in paragraph (b)(2) of this section) on the share for the taxable year of the shareholder to which that portion relates, plus the preferred discount amount (as defined below), if any, for the taxable year. For purposes of this section, the preferred discount amount for a taxable year is the amount that bears the same ratio to the total amount of preferred discount (as described in § 1.1295–2(b)(2)(i)) on the share as the number of days that the taxpayer held the share in the taxable year bears to the number of days after the date the taxpayer acquired the share and up to (and including) the share's redemption date as established under the principles of § 1.305–5(b). Notwithstanding the preceding sentence, the preferred discount amount for a taxable year is zero if the preferred discount on the share at the time of its acquisition by the shareholder was less than an amount equal to 1/4 of 1 percent of the redemption price of the stock, multiplied by the number of complete years from the date of acquisition of the stock to the redemption date of the stock.

(2) *Periodic dividend amount.* A periodic dividend amount is the amount payable with respect to a share, whether on a cumulative or noncumulative basis, for a period (wholly or partly within the shareholder's taxable year) for which dividends on the share are calculated based upon the redemption or liquidation price of the share multiplied by a fixed percentage rate.

[1] This proposed regulation was published on April 1, 1992, at 57 Fed. Reg. 11024.

(c) *Special rules of application*—(1) *Earnings and profits disregarded.* The amounts to be included in income pursuant to this section are determined without regard to the earnings and profits of the foreign corporation with respect to which the special preferred QEF election applies.

(2) *Year of inclusion.* The shareholder includes the preferred QEF amount in its taxable year without regard to the taxable year of the foreign corporation with respect to which the special preferred QEF election applies.

(3) *Character of inclusions.* The shareholder includes all preferred QEF amounts in income as ordinary earnings.

(4) *Treatment of distributions.* Distributions received by a shareholder on shares subject to a special preferred QEF election that are paid out of earnings and profits of the foreign corporation are not included in gross income of the shareholder to the extent the distributions do not exceed the preferred QEF amounts (other than any portion of preferred QEF amounts consisting of preferred discount amounts) previously includible in income pursuant to this section. These distributions will, however, be treated as dividends for all other purposes of the Code and regulations. Amounts distributed to a shareholder with respect to shares subject to a special preferred QEF election that exceed amounts previously included in income under this section with respect to such shares are treated for all purposes of the Code and regulations as a distribution of property subject to the rules of section 301.

(5) *Basis adjustment rules.* The adjusted basis of a shareholder in shares that are subject to a special preferred QEF election shall be—

(i) Increased by any amount that is included in the gross income of the shareholder under paragraph (a) of this section; and

(ii) Decreased by any dividends (not to exceed the amount included in gross income under paragraph (a) of this section) actually paid to the shareholder in respect of such shares.

(6) *Effect limited to electing shareholder.* This section does not apply to the foreign corporation with respect to which a special preferred QEF election

applies. Accordingly, the provisions of this section will not affect the foreign corporation's calculation of its earnings and profits for any purpose of the Code or regulations. In addition, the rules of this section apply only for purposes of determining the tax consequences for holders of shares subject to the election. Thus, the election shall have no effect on the application of the Code or regulations with respect to the tax consequences of the ownership of shares that are not subject to the election, including for purposes of determining whether any distributions from the foreign corporation with respect to such shares should be treated as having been included in the income of any United States person pursuant to section 1293(c) or section 959.

(d) *Examples*. The following examples illustrate the rules of paragraphs (a), (b) and (c) of this section. Although these examples assume a 30-day month, 360-day year, any reasonable counting method may be used to compute the length of accrual periods. For purposes of simplicity, the relevant amounts as stated are rounded to two decimal places. However, the computations do not reflect any such rounding convention. The examples are as follows:

Example 1. Preferred QEF amount—(i) *Facts.* (A) On May 1, 1998, A, an individual who files his returns on a calendar year basis, purchased for $10,000 in a single secondary market transaction 100 shares of nonconvertible Class A $100 par value preferred stock (the Class A Stock) of FC, a foreign corporation with a taxable year ending on March 31.

(B) The terms of the Class A Stock provide for a mandatory redemption of the Class A Stock by the issuer at par on June 1, 2012. The Class A Stock is not redeemable pursuant to an issuer call or holder put on any other date. Each share of Class A Stock provides for a semi-annual cumulative distribution payable in dollars on June 1 and December 1 equal to one-half the product of the par value of the Class A Stock and the applicable annual dollar LIBOR in effect on the distribution date immediately prior to the relevant distribution date. The shares of the Class A stock are qualified preferred shares in the hands of A. A purchases no other qualified preferred shares of FC during its 1998 or 1999 taxable years.

(C) A made a special preferred QEF election for A's taxable year ended December 31, 1998, which applies to the Class A Stock acquired by A on May 1, 1998. FC is a PFIC under section 1296 for its taxable year ending March 31, 1999, but FC is not a PFIC for its taxable year ending March 31, 2000. FC paid no current dividends on June 1, 1998, and December 1, 1998, paid the June 1, 1999, dividend currently on June 1, 1999, together with accumulated distributions from June 1, 1998, and December 1, 1998, and paid the December 1, 1999, dividend currently on December 1, 1999. The applicable annual LIBOR is 8 percent on December 1, 1997, 7 percent on June 1, 1998, 9 percent on December 1, 1998, 10 percent on June 1, 1999, and 9 percent on December 1, 1999. FC had sufficient earnings and profits, within the meaning of section 312, for its taxable year ending on March 31, 2000, so that actual distributions to all shareholders of Class A Stock in that year were treated as paid out of earnings and profits of FC.

(ii) *Tax consequences to A for A's taxable year ending December 31, 1998.* As required under paragraph (a) of this section, A must include in gross income for its 1998 taxable year the 1998 preferred QEF amount. The preferred QEF amount, as determined under paragraph (b) of this section, for A's 1998 taxable year is the ratable portion of each periodic dividend amount for that year. For 1998, there are three periodic dividend amounts: The periodic dividend amount for the period from December 1, 1997, to June 1, 1998 (periodic dividend amount 1), the periodic dividend amount for the period from June 1, 1998, to December 1, 1998 (periodic dividend amount 2), and the periodic dividend amount for the period from December 1, 1998, to June 1, 1999 (periodic dividend amount 3). Periodic dividend amount 1 in respect of each share owned by A is $4 (1/2 multiplied by the applicable annual LIBOR of 8 percent set on December 1, 1997, multiplied by the $100 amount payable on redemption). Because A acquired the shares on May 1, 1998, A's ratable portion of periodic dividend amount 1 for 1998 is approximately $.67 (30/180 multiplied by $4) per share. Periodic dividend amount 2 in respect of each share owned by A is $3.50 (1/2 multiplied by the applicable annual LIBOR of 7 percent set on June 1, 1998, multiplied by $100). Because A owned the shares for the entire period associated with periodic dividend amount 2, A's ratable portion of periodic dividend amount 2 for 1998 is the full $3.50 per share. Periodic dividend amount 3 in respect of each share owned by A is $4.50 (1/2 multiplied by the applicable annual LIBOR of 9 percent set on December 1, 1998, multiplied by $100). Because the portion of 1998 associated with periodic dividend amount 3 is only the month of December, 1998, A's ratable portion of periodic dividend amount 3 for 1998 is approximately $.75 (30/180 multiplied by $4.50). Accordingly, A's preferred QEF amount for 1998 is approximately $4.92 ($.67 + $3.5 + $.75) per share. A must include approximately $492 (approximately $4.92 per share, multiplied by 100 shares) in income as ordinary earnings for its 1998 tax year even though FC paid no actual dividend to shareholders of Class A Stock for the period in 1998 during which A held the Class A Stock.

(iii) Tax consequences to A for A's taxable year ending December 31, 1999. As required under paragraph (a) of this section, A includes in gross income for its 1999 taxable year its preferred QEF amount for 1999. The preferred QEF amount, as determined under paragraph (b) of this section, for A's 1999 taxable year is the ratable portion of each periodic dividend amount for that year. For 1999, there are three periodic dividend amounts: The periodic dividend amount for the period from December 1, 1998, to June 1, 1999 (periodic dividend amount 1), the periodic dividend amount for the period from June 1, 1999, to December 1, 1999 (periodic dividend amount 2), and the periodic dividend amount for the period from December 1, 1999, to June 1, 2000 (periodic dividend amount 3). Periodic dividend amount 1 in respect of each share owned by A is $4.50 (1/2 multiplied by the applicable annual LIBOR of 9 percent set on December 1, 1998, multiplied by $100). Because A held each share of Class A Stock for five months in 1999 for the period associated with periodic dividend amount 1, A's ratable portion of periodic dividend amount 1 for 1999 is approximately $3.75 (150/180 multiplied by $4.50). Periodic dividend amount 2 in respect of each share owned by A is $5 (1/2 multiplied by the applicable annual LIBOR of 10 percent set on June 1, 1999, multiplied by $100). Because A owned the share for the entire period associated with periodic dividend amount 2, A's ratable portion of periodic dividend amount 2 for 1999 is the full $5. Periodic dividend amount 3 in respect of each share owned by A is $4.50 (1/2 multiplied by the applicable annual LIBOR of 9 percent set on December 1, 1999, multiplied by $100). Because A held each share of Class A Stock for one month in 1999 for the period associated with periodic dividend amount 3, A's ratable portion of periodic dividend amount 3 for 1999 is approximately $.75 (30/180 multiplied by $4.50). Accordingly, A's preferred QEF amount for 1998 is approximately $9.50 ($3.75 + $5 + $.75). A must include approximately $950 ($9.50 per share, multiplied by 100 shares) in income as ordinary income for its 1999 taxable year even though FC was not a PFIC for FC's taxable year ending in 2000. The current distributions and arrearages actually paid to A with respect to the Class A Stock are not includible in income by A under paragraph (c)(4) of this section because they constitute amounts previously included in income.

Example 2. Preferred Discount—(i) *Facts.* The facts are the same as in *Example 1* except that A acquired the 100 shares of Class A Stock for $9000.

(ii) *Tax Consequences to A for A's taxable year ending December 31, 1998.* (A) Because the Class A Stock is fixed term preferred stock (as described in § 1.1295–2(b)(1)(vii)) and A acquired each share of the Class A stock with $10 of preferred discount, as described in § 1.1295–2(b)(2), A's preferred QEF amount to be included by A for the taxable year consists of the sum of the ratable daily portion of each periodic dividend amount, as calculated in paragraph (d)(ii) of *Example 1* of this section, plus the preferred discount amount described in paragraph (b)(1) of this section.

(B) The preferred discount amount with respect to each share is approximately $.47 ($10 multiplied by 240 days/5070 days to maturity). A must include approximately $47 ($.47 per share, multiplied by 100 shares), together with the amount calculated in paragraph (d)(ii) of *Example 1* of this section, in income as ordinary earnings for its 1998 tax year even though FC paid no actual dividend to shareholders of Class A Shares for the period in 1998 during which A held the Class A Stock.

(iii) *Tax consequences to A for A's taxable year ending December 31, 1999.* The portion of the preferred discount on each share includible under paragraph (a) of this section is approximately $.71 ($10 multiplied by 360 days/5070 days to maturity). A must include this amount, together with the amount calculated in paragraph (d)(iii) of *Example 1* of this section, in income as ordinary earnings for its 1999 tax year even though FC was not a PFIC for FC's taxable year ending in 2000. The current distributions and arrearages actually paid to A in 1999 with respect to the Class A Stock are not includible in income by A under paragraph (c)(4) of this section, because they constitute amounts previously included in income.

(e) *Effective date.* The rules under this section apply with respect to qualified preferred stock subject to a special preferred QEF election made after the date that is 30 days after the date of publication of this document as a final regulation.

Par. 3. Section 1.1295–2 is added to read as follows:

§ 1.1295–2 Special Preferred QEF Election.

(a) *In general.* This section provides rules permitting certain shareholders to make a special election under section 1295 (special preferred QEF election) in lieu of the election described in § 1.1295–1[2] and Notice 88–125, 1988–2 C.B. 535 (see § 601.601(d)(2)(ii)(*b*) of this chapter), with respect to certain preferred shares (qualified preferred shares) of a foreign corporation that certifies either that it is a PFIC (as defined in § 1.1291–1(b)(1)(i))[3] or that it reasonably believes that it is a PFIC. In order to make a special preferred QEF election, a shareholder must satisfy the stock ownership requirement of paragraph (c)(2) of this section. A special preferred QEF election of a shareholder applies only to those qualified preferred shares acquired and held directly by the shareholder in the taxable year of the shareholder for which the election is made. A shareholder making a special preferred QEF election must account for dividend income on shares subject to the election under the special income inclusion rules described in § 1.1293–2, rather than under the general income inclusion rules of section 1293 and § 1.1293–1. In addition, for purposes of determining the tax consequences of owning shares subject to the special preferred QEF election, an electing shareholder must treat the foreign corporation as a PFIC for the entire period during which the shareholder continues to hold any of such shares. Paragraph (b) of this section defines qualified preferred share. Paragraph (c) of this section provides rules for determining who may make the special preferred QEF election. Paragraph (d) of this section provides rules concerning the effect of the election. Paragraph (e) of this section provides rules for the time and manner of making the election. Paragraph (f) of this section sets forth the annual reporting requirement for the election. Paragraph (g) of this section provides rules concerning the possible termination or invalidation of the election. For the applicability date of this section, see paragraph (h) of this section.

(b) *Qualified preferred share defined*—(1) *In general.* For purposes of this section, a share of a foreign corporation is a qualified preferred share only if—

(i) The share was originally issued for cash or in exchange for qualified preferred shares of the foreign corporation in a transaction to which section 354(a)(1) applied;

(ii) If the share were to constitute a debt obligation, the share would be in registered form within the meaning of § 5f.103–1(c) of this chapter;

(iii) All amounts payable with respect to the share are denominated in U.S. dollars and are not determined by reference to the value of a currency other than the U.S. dollar;

(iv) The share is limited and preferred as to dividends and does not participate in corporate growth to any significant extent within the meaning of section 1504(a)(4)(B);

(v) The share has a fixed redemption or liquidation price;

(vi) The share provides for cumulative or noncumulative dividend rights that are limited to an annual (or shorter period) amount computed by multiplying either the redemption or liquidation price of the share by a specified index described in § 1.446–3(c)(2)(i), (iii), or (iv) (specified index), or by a specified index periodically re-established pursuant to an auction reset mechanism, set in advance of the period with respect to which the specified index applies;

(vii) If the share may be redeemed under circumstances described in § 1.305–5(b) such that redemption premium (as described in § 1.305–5(b)) could be treated under section 305(c) as a constructive distribution (fixed term preferred stock), the share was not issued with redemption premium exceeding the de minimis amount described in section 305(c)(1) and § 1.305–5(b)(1);

(viii) If the share may not be redeemed under circumstances described in § 1.305–5(b) such that redemption premium would not be treated under section 305 as a constructive distribution (perpetual preferred stock), the share does not provide shareholders with the right to receive an amount upon liquidation or redemption that exceeds the issue price of the share (as determined under the principles of section 1273(b)) by an amount in excess of 5 percent of such liquidation or redemption amount;

(ix) If redeemable, the share is redeemable only in whole and not in part and is not subject to mandatory redemption within five years of the issue date of the share. Further, the share is not subject to a holder put or issuer call that, based on all the facts and circumstances as of the issue date of the share, is more likely than not to be exercised at a time within five years of the issue date;

(x) If convertible, the share is not convertible into a share other than a share meeting all the conditions set forth in paragraphs (b)(1)(i) through (b)(1)(ix) of this section; and

(xi) The issuer of the share has indicated in an offering document relating to the original issuance of the share or in a written statement available to U.S. holders that the issuer has no current intention or belief that it will not pay dividends on the share on a current basis and that the share meets the conditions set forth in paragraphs (b)(1)(i) through (b)(1)(x) of this section and this paragraph (b)(1)(xi).

(2) *Special rules for shares acquired in secondary market transactions*—(i) *Fixed term preferred stock.* A share of fixed term preferred stock (as described in paragraph (b)(1)(vii) of this section) that satisfies the conditions set forth in paragraph (b)(1) of this section and that is acquired in a transaction other than in connection with the initial issuance of the share (a secondary market transaction), shall constitute a qualified preferred share with respect to a shareholder, but only if the shareholder acquires the share for cash and the share has preferred discount (as defined below) that is less than or equal to an amount equal to 1 percent of the redemption price, multiplied by the number of complete years from the date of acquisition of the share to the redemption date as established under the principles of § 1.305–5(b). Sales of shares to bond houses, brokers, or similar persons or organizations acting in the capacity as underwriters, placement agents, or wholesalers are ignored for purposes of determining whether a share is acquired in connection with the initial issuance of the share. For purposes of this section, the preferred discount for a share is the excess of the redemption price of the share payable on the redemption date over the shareholder's acquisition cost for the share.

(ii) *Perpetual preferred stock.* A share of perpetual preferred stock, within the meaning of paragraph (b)(1)(viii) of this

[2] This proposed regulation was published on April 1, 1992, at 57 Fed. Reg. 11024.

[3] This proposed regulation was published on April 1, 1992, at 57 Fed. Reg. 11024.

section, that satisfies the conditions set forth in paragraph (b)(1) of this section and that is acquired in a secondary market transaction, shall constitute a qualified preferred share with respect to the shareholder, but only if the shareholder acquires the share for cash and the amount payable upon liquidation of the share exceeds the shareholder's acquisition cost for the share by an amount less than or equal to 10 percent of such liquidation amount.

(iii) *Examples.* The following examples illustrate the rules of this paragraph (b)(2).

Example 1—(i) *Facts.* On May 1, 1998, A, an individual who files her return on a calendar year basis, purchases for $9000 cash in a single secondary market transaction (as defined in paragraph (b)(2)(i) of this section) 100 shares of nonconvertible Class A $100 par value preferred stock (Class A Stock) of FC, a foreign corporation with a taxable year ending March 31. The terms of the Class A Stock satisfy all the conditions described in paragraph (b)(1) of this section and provide for a mandatory redemption of the Class A Stock by the issuer in U.S. dollars at par on June 1, 2012. The Class A Stock is not redeemable pursuant to an issuer call or holder put on any other date.

(ii) *Analysis.* In order for A to make a special preferred QEF election with respect to the Class A Stock acquired by A, the Class A Stock acquired must constitute qualified preferred shares. Although the Class A Stock meets the requirements for qualified preferred shares set forth in paragraph (b)(1) of this section, the stock also must satisfy the requirements described in paragraph (b)(2) because A acquired the stock in a secondary market transaction. Because the terms of the Class A Stock provide that the stock will be redeemed by the issuer on June 1, 2012, the stock constitutes fixed term preferred stock within the meaning of paragraph (b)(1)(vii) of this section. A purchased the Class A Stock for $90 per share, representing a $10 discount ($100 June 1, 2012, per share redemption price less $90 acquisition cost). Because this $10 discount, which constitutes preferred discount within the meaning of paragraph (b)(2)(i) of this section, is less than $14 (1 percent of the redemption price multiplied by 14 (the number of complete years until the mandatory redemption date)), the Class A Stock acquired by A satisfies the conditions of paragraph (b)(2)(i) of this section and therefore constitutes qualified preferred shares.

Example 2—(i) *Facts.* The facts are the same as in *Example 1*, except that A acquires the 100 shares of Class A Stock for $8000.

(ii) *Analysis.* In this case, A purchased the Class A Stock for $80 per share, representing a $20 discount ($100 June 1, 2012, redemption price less $80 acquisition cost). Because this $20 of preferred discount is greater than $14 (1 percent of the redemption price multiplied by 14 (the number of complete years until the mandatory redemption date)), the Class A Stock fails to satisfy the conditions of paragraph (b)(2)(i) of this section and therefore fails to qualify as qualified preferred shares.

(c) *Who may make the election*—(1) *In general.* A U.S. person that acquires qualified preferred shares for cash or in a nonrecognition transaction described in § 1.1291–6(a)[4] (nonrecognition transaction) and that holds such shares directly may make a special preferred QEF election, provided that, in the case of shares acquired in a nonrecognition transaction, either the qualified preferred shares are treated as stock of a pedigreed QEF, as defined in § 1.1291–1(b)(2)(ii), immediately prior to the nonrecognition transaction, or the gain, if any, realized on the transaction would be recognized under § 1.1291–6(b) with respect to the nonrecognition transaction. A special preferred QEF election will not apply to any shares with respect to which the electing shareholder is an indirect shareholder, within the meaning of § 1.1291–1(b)(8). Solely for purposes of this section, partnerships, S corporations, trusts and estates (pass-through entities) that directly own qualified preferred shares are treated as shareholders that may make a special preferred QEF election. A shareholder may not make a special preferred QEF election if at any time the shareholder made a section 1295 election (other than a special preferred QEF election) with respect to the foreign corporation. A shareholder may not make a special preferred QEF election unless the shareholder satisfies the stock ownership requirements set forth in paragraph (c)(2) of this section, and the shareholder receives from the foreign corporation the statement described in paragraph (c)(3) of this section.

(2) *Ownership requirement.* A holder of qualified preferred shares of a foreign corporation may make a special preferred QEF election only if, at all times during the taxable year of the shareholder, the shareholder does not own, directly, indirectly, or constructively, within the meaning of section 958, five percent or more of the vote or value of any class of stock of the foreign corporation. The five percent vote or value limitation must be satisfied for each taxable year of the shareholder during which the shareholder continues to hold shares subject to the special preferred QEF election.

(3) *Statement from corporation.* A shareholder may make the special preferred QEF election only if the foreign corporation has provided a written statement relating to the taxable year of the corporation that ends with or within the taxable year of the shareholder for which the election is made certifying either that the foreign corporation is, or that it reasonably believes that it is, a PFIC, and that it is not a controlled foreign corporation within the meaning of section 957(a) for such taxable year of the corporation. The statement must be provided directly to the electing shareholder or in a disclosure or other document generally available to all U.S. holders. Electing shareholders must retain a copy of the statement for their records.

(d) *Effect of election*—(1) *In general.* Unless terminated or invalidated pursuant to paragraph (g) of this section, shares subject to a special preferred QEF election will be treated as shares of a pedigreed QEF (as defined in § 1.1291–1(b)(2)(ii)) for all taxable years of the foreign corporation that are included wholly or partly in the shareholder's holding period of the shares. A special preferred QEF election applies to all qualified preferred shares owned directly by the shareholder that are acquired in the taxable year of the election. Separate special preferred QEF elections may be made for qualified preferred shares acquired in other taxable years of the taxpayer. A special preferred QEF election is personal to the shareholder that made the election and does not apply to a transferee of the shares. A shareholder that has made a special preferred QEF election may not make, with respect to the foreign corporation, any other election permitted under sections 1291 through 1297 and the regulations under those sections, including a section 1295 election as described in § 1.1295–1 and Notice 88–125, 1988–2 C.B. 535 (see § 601.601(d)(2)(ii)(b) of this chapter), for any period during which the special preferred QEF election remains in effect with respect to any shares of the shareholder.

(2) *Continued PFIC Characterization.* By making the special preferred QEF election, the shareholder agrees to treat the foreign corporation as a PFIC with respect to qualified preferred shares subject to the election at all times during its holding period for such shares, without regard to whether the foreign corporation is a PFIC for any taxable year of the foreign corporation during which the preferred QEF election remains in effect.

(3) *Section 1293 inclusions.* For each taxable year of the shareholder to which an election under this section applies, the shareholder must include in income the preferred QEF amount, as defined in

[4] This proposed regulation was published on April 1, 1992, at 57 Fed. Reg. 11024.

§ 1.1293–2, in the manner and under the rules provided in that section.

(e) *Time for and manner of making the special preferred QEF election*—(1) *Time for making the election.* A special preferred QEF election must be made on or before the due date, as extended, for filing the shareholder's return for the taxable year during which the shareholder acquired the qualified preferred shares for which the election is being made. A special preferred QEF election may not be made for those shares at any other time pursuant to any other provision of the Code or regulations.

(2) *Manner of making the election*—(i) *In general.* A shareholder makes the special preferred QEF election under this section for all qualified preferred shares of a foreign corporation acquired during the shareholder's taxable year by checking the appropriate box in Form 8621 (Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund), Part I, for making the section 1295 election, and indicating in the margin of Part I that the shareholder is making a special preferred QEF election with respect to certain specified shares. The shareholder also must report the preferred QEF amount for the taxable year of the election on Line 6a of Part II of Form 8621. In addition, the shareholder must attach to Form 8621 the statement (preferred QEF statement) described in paragraph (e)(2)(ii) of this section, signed by the shareholder under penalties of perjury, stating that the information and representations provided in the preferred QEF statement are true, correct, and complete to the best of the shareholder's knowledge and belief.

(ii) *Preferred QEF statement contents.* The preferred QEF statement must include the following information and representations:

(A) The first taxable year of the shareholder for which the special preferred QEF election is made;

(B) The number of shares subject to the election, their acquisition date(s) and acquisition price(s), and the class designation(s) of the shares;

(C) A representation by the shareholder that it did not at any time during its taxable year own directly, indirectly, or constructively, within the meaning of section 958, five percent or more of the vote or value of any class of stock of the foreign corporation with respect to which the election applies;

(D) A representation by the shareholder that it has obtained the written statement described in paragraph (c)(3) of this section; and

(E) A representation by the shareholder that it has never made a section 1295 election other than a special preferred QEF election with respect to the foreign corporation.

(f) *Annual reporting requirement.* For each taxable year of a shareholder during which the shareholder holds shares of a foreign corporation subject to one or more special preferred QEF elections, the shareholder must file Form 8621 with respect to the foreign corporation regardless of whether the foreign corporation is or is not a PFIC under section 1296 during any portion of the taxable year. The shareholder must indicate in the margin of Part I of Form 8621 the number of special preferred QEF elections of the shareholder that remain in effect with respect to the foreign corporation. In addition, the shareholder must report, on Line 6a of Part II of Form 8621, the aggregate of the preferred QEF amounts for all relevant special preferred QEF elections in effect for the taxable year.

(g) *Termination or invalidation of election*—(1) *In general.* A sale, exchange or other disposition of a share that is subject to a special preferred QEF election will terminate the special preferred QEF election with respect to that share. In addition, the Commissioner may, in the Commissioner's discretion, terminate or invalidate a special preferred QEF election if a shareholder that made the election fails to satisfy the initial or ongoing requirements of the election. Once made, a special preferred QEF election may not be terminated or invalidated by the shareholder.

(2) *Effect of termination or invalidation.* Termination of a special preferred QEF election by the Commissioner will be effective on the first day of the shareholder's first taxable year following the last taxable year of the shareholder for which the requirements of the election are satisfied. For purposes of sections 1291 through 1297 and the regulations thereunder, the holding period of qualified preferred shares subject to an election that has been terminated will be treated as beginning on the effective date of the termination. A shareholder that has made an election that is invalidated by the Commissioner will be treated for purposes of sections 1291 through 1297 and the regulations thereunder as if the shareholder never made the election.

(h) *Effective date.* An election under this section may only be made with respect to qualified preferred shares that are issued after the date that is 30 days after the date of publication of this document as a final regulation.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on December 23, 1996, 8:45 a.m., and published in the issue of the Federal Register for December 24, 1996, F.R. 67752)

Notice of Proposed Rulemaking and Notice of Public Hearing

Treatment of Obligation-Shifting Transactions

REG–209817–96

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the treatment of certain multiple-party financing transactions in which one party realizes income from leases or similar agreements and another party claims deductions related to that income. In order to prevent tax avoidance, the proposed regulations recharacterize these transactions in a manner that clearly reflects income. The proposed regulations affect only persons that engage in these transactions. The regulations generally do not apply to routine transactions lacking characteristics of tax avoidance. This document also provides notice of a public hearing on the proposed regulations.

DATES: Written comments, requests to appear, and outlines of topics to be discussed at the public hearing scheduled for April 29, 1997, at 10 a.m. must be received by April 8, 1997.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–209817–96), Room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–209817–96), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the ‘‘Tax Regs’’ option of the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 7th Floor, 1111 Constitution Avenue NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Jonathan Zelnik at (202) 622–3940; concerning submissions and the hearing, Christina Vasquez at (202) 622–7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget,** Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service,** Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224. Comments on the collection of information should be received by April 8, 1997. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the Internal Revenue Service, including whether the collection will have a practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of service to provide information.

The collection of information is in § 1.7701(l)–2(j). This information is required by the IRS to verify pass-through entity compliance with § 1.7701(l)–2. This information will be used to determine whether the amount of tax has been computed correctly. The collection of information is mandatory. The likely recordkeepers are businesses and other organizations. Estimated total annual recordkeeping burden: 500 hours. Estimated average annual burden per recordkeeper: 5 hours. Estimated number of recordkeepers: 100.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax information are confidential, as required by 26 U.S.C. 6103.

Background

The IRS and Treasury Department have become aware of multiple-party financing transactions (‘‘stripping transactions’’) intended to allow one party to realize income from a lease or similar agreement and to allow another party to report deductions related to that income (for example, cost recovery or rental expenses). Notice 95–53, 1995–2 C.B. 334, describes several examples of these transactions, including transferred basis transactions, transfers of partnership interests, and variations involving licenses, service contracts, and prepayment, front-loading, and retention of rights to receive future payments.

Notice 95–53 states the position of the IRS that the claimed tax treatment of these transactions improperly separates income from related deductions and that the transactions do not produce the tax consequences desired by the parties. The notice also states that regulations will be issued under section 7701(l) of the Internal Revenue Code recharacterizing stripping transactions any significant element of which is entered into or undertaken on or after October 13, 1995. The notice requested comments regarding those regulations.

The IRS received only one set of comments in response to Notice 95–53. Those comments recommended that the regulations under section 7701(l) address a broader class of transactions than was described in the notice. Specifically, they recommended that the regulations defer the recognition of income in circumstances where there is an advance receipt or assignment of future income and there is the potential for the transactions to become stripping transactions. They also recommended that the regulations recharacterize these transactions without regard to whether there is a tax avoidance purpose. The comments reflected a desire for the regulations to produce an economic accrual of income and to enable taxpayers to determine the proper tax accounting for their transactions without regard to subsequent events.

The proposed regulations generally follow the notice and do not expand the class of transactions subject to recharacterization. The regulations do not require taxpayers to make any assumptions as to subsequent events. They are intended to produce tax results that conform to the economic substance of the transactions that they address. Furthermore, the regulations generally apply to transactions whether or not the parties have a tax avoidance purpose.

Explanation of Provisions

1. General approach

Section 7701(l) authorizes the Secretary to ‘‘prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among any 2 or more of such parties where the Secretary determines that such recharacterization is appropriate to prevent avoidance of any tax imposed by [the Internal Revenue Code].’’ The proposed regulations recharacterize transactions in which the transferee (‘‘the assuming party’’) assumes obligations or acquires property subject to obligations under an existing lease or similar agreement and the transferor (‘‘the property provider’’) or any other party has already received or retains the right to receive amounts that are allocable to periods after the transfer. The recharacterization reflects the general principle that a taxpayer who is treated for federal income tax purposes as the owner of rental property must recognize income that accrues during its period of ownership. *See, e.g.*, *Steinway & Sons v. Commissioner*, 46 T.C. 375 (1966), *acq.*, 1967–2 C.B. 3; *Alstores Realty Corp. v. Commissioner*, 46 T.C. 363 (1966), *acq.*, 1967–2 C.B. 1.

For the period in which an assuming party in such a transaction is a party to the lease or similar agreement, the recharacterization requires the assuming party to report income on a level-rent basis calculated using the rules of the constant rental accrual method described in § 1.467–3(d) as proposed on June 3, 1996 (IA–292–84, 61 FR 27834, 27844). Thus, the assuming party is required to recognize rental income for the period in which it owns the property or leasehold interest. In addition, the transaction is recharacterized to include additional consideration in the form of a note provided by the assuming party to the property provider for the transfer of the property, resulting in interest income and expense for which the parties must account as appropriate. The property provider also must adjust its income for any differences between amounts it recognized and amounts it would have recognized if it had reported income on a level-rent basis for the periods that it owned the property or leasehold interest. Finally, to account for any differences in timing or amount between payments the property provider actually receives after the transaction and payments treated as being made to the property provider under the note from the assuming party, the property provider is treated as an obligor or obligee under a second loan, for which the property provider must account accordingly.

2. Obligation-shifting transactions

The proposed regulations are not intended to recharacterize transactions with little potential for tax avoidance. Taken together, the definition of ''obligation-shifting transaction'' and the enumerated exceptions limit the scope of the regulations to transactions that are not routine and that involve shifting of substantial amounts of income away from the taxpayer that recognizes deductions related to the income.

The proposed regulations apply to obligation-shifting transactions, which are defined as any transaction in which an assuming party assumes a property provider's obligations to a property user (or acquires property subject to a property provider's obligations to a property user) under a lease or similar agreement if the property provider or any other party has already received, or retains the right to receive, amounts that are allocable to periods after the transaction. The regulations define obligations under a lease or similar agreement as including a continuing obligation to make property available to the lessee or the ultimate user of the property. These obligations typically give rise to deductions, such as for cost recovery or, in the case of a master-lease/sublease arrangement, for payments under a master lease. The advance receipt of amounts that are allocable to periods after the obligation-shifting transaction often results in accelerated taxable income for the recipient. Thus, the definition describes transactions in which there is the potential for one party to recognize income but a different party to recognize deductions associated with that income.

In some transactions identified in Notice 95–53, one party sells, assigns, or otherwise transfers to a third party the right to receive future payments under a lease and includes as current income the amount received as consideration for the transfer. The underlying property (subject to the lease) is later transferred in a transaction intended to qualify as a transferred basis transaction. These transactions are within the scope of the regulations because the property transferee assumes obligations or acquires the property subject to the obligation to make the property available to the lessee and the property transferor already received amounts that are allocable to periods after the transaction by reason of the assignment of rights to receive future payments. In other transactions, the property transferor does not assign the right to future rental amounts but instead receives prepayment from the lessee or retains the right to receive future amounts over time. Both variations likewise are within the scope of the regulations.

The proposed regulations adopt an aggregate view of partnerships, treating each partner as having a proportionate share of the rights and obligations of the partnership. Thus, for example, if a partnership assigns its right to receive future amounts under a lease and allocates to its current partners the amount recognized, a later transfer of a partnership interest is an obligation-shifting transaction because the transferee partner assumes an allocable share of the partnership's obligation to make the property available to the lessee and because the transferor partner is treated as having already received amounts that are allocable to periods after the transaction. See *Example 3* of the proposed regulations. In appropriate cases, the IRS may assert other authorities to prevent the use of a partnership to effect an improper separation of income from related deductions. *See, e.g.*, § 1.701–2(d) (*Example 7*).

The proposed regulations also generally treat an obligation-shifting transaction as occurring if a subsidiary that is a member of a consolidated group becomes a nonmember at a time when the subsidiary has received payments under a lease or similar agreement that are allocable to periods after the transaction.

3. Lease or similar agreement

Under the proposed regulations, an obligation-shifting transaction involves a lease or similar agreement. The regulations define this term broadly to include any contract for the use or enjoyment of tangible or intangible property, including leaseholds, licenses, other non-fee interests in property, and other contracts (including service contracts) involving the use or enjoyment of property if the value of that use or enjoyment is more than *de minimis*. The proposed regulations, therefore, do not apply to service contracts that do not involve the use or enjoyment of property. The definition of obligation-shifting transaction, however, does not restrict the IRS's ability to challenge these transactions under other authorities. For instance, even if a transaction is not within the scope of the proposed regulation, the IRS may challenge it under one or more of the authorities identified in Notice 95–53.

The IRS requests comments on whether additional guidance is needed on the definition of lease or similar agreement.

4. Exceptions

The proposed regulations are not intended to recharacterize otherwise routine transactions, such as the incorporation of an entire line of business that does not involve significant shifting of income and deductions. See Rev. Rul. 80–198, 1980–2 C.B. 113, subject to the limitations described therein. Accordingly, the regulations provide a number of objective exceptions that generally will protect routine transactions from recharacterization. The regulations do not apply to transactions in which the amounts that are allocable to future periods but are not transferred are less than or equal to $100,000. The regulations do not apply to transactions in which total payments (including the aggregate expected future value of all contingent consideration) under the lease or similar agreement are not reasonably expected to exceed $250,000. The regulations do not apply to transactions in which the fair market value of the property that is subject to the lease or similar agreement and is transferred in the obligation-shifting transaction, plus the value of the amounts that are already received or retained by the property provider but are allocable to periods after the obligation-shifting transaction, is less than ten percent of the total assets (other than Class I and Class II assets as described in § 1.1060–1T(d) and debt issued by the property provider) transferred by the property provider in the transaction. The regulations do not apply to transactions in which the lease or similar agreement is a disqualified leaseback or long-term agreement within the meaning of § 1.467–3(b). The regulations do not apply to transactions described in section 381(a), unless the transaction is deemed to be an obligation-shifting transaction under proposed § 1.7701(l)–2(k). Finally, the regulations provide that a transaction is exempt from recharacterization if the parties to the transaction establish to the satisfaction of the Commissioner that the transaction does not present a significant potential for tax avoidance.

Because the purpose of recharacterization under section 7701(l) is to prevent tax avoidance, these objective exceptions are unavailable for transactions entered into with a principal purpose of substantially reducing the present value of the aggregate tax liability of the property provider, the assuming party, and any other party whose taxable income is determined by reference to the taxable income of the property provider or the assuming party.

5. Recharacterization

The proposed regulations recharacterize an obligation-shifting transaction in order to ensure that the property provider and the assuming party both report the income from the underlying property allocable to their respective periods of ownership.

For purposes of determining the amounts that are allocable to periods under the lease or similar agreement, the proposed regulations apply a rent-leveling process based on the constant rental accrual method described in § 1.467–3(d) to all amounts that are treated as payable under the lease or similar agreement. At the time of the obligation-shifting transaction, the level rental amount is determined for the entire term of the lease or similar agreement using 110 percent of the applicable Federal rate based on that term. The amounts that are treated as payable under the lease or similar agreement at the time of the obligation-shifting transaction are the amounts that have already been paid to the property provider and the future amounts that, immediately before the obligation-shifting transaction, are payable to the property provider. Thus, if the property provider assigns the right to receive payments to a third party in exchange for consideration, the consideration is treated as an amount received under the lease or similar agreement. Because the property provider no longer has the right to receive the payments assigned to the third party, those payments (whether past or future) are not treated as amounts that are payable to the property provider for purposes of calculating the level rental amount.

The proposed regulations recharacterize an obligation-shifting transaction by treating the assuming party and the property provider as follows:

The assuming party is treated as acquiring the right to receive all amounts that are allocable to periods after the obligation-shifting transaction. The assuming party includes these amounts in income for the periods that it owns the property.

To reflect the amounts that the assuming party is treated as receiving under the recharacterization but that it does not actually receive, the assuming party also is treated as providing additional consideration to the property provider in the form of a note (a ‘‘section 7701(l) note’’). The original principal balance of the section 7701(l) note equals the excess of the present value of the amounts that are allocable to periods after the obligation-shifting transaction over the present value of the amounts that are payable to the assuming party.

The property provider must adjust its income to the extent that it accounted for income under the lease or similar agreement before the obligation-shifting transaction in a manner inconsistent with the level-rent method described above. The adjustment, which can increase or decrease the property provider’s income, equals the principal balance of the section 467 loan that would have existed if the property provider had been using the constant rental accrual method to account for amounts under the lease or similar agreement that are allocable to periods before the obligation-shifting transaction, reduced by any existing section 467 loan if the lease or similar agreement is a section 467 rental agreement. The constant rental amount is calculated using the amounts that are treated as payable under the lease or similar agreement.

Finally, to account for any differences in timing or amount between payments the property provider actually receives after the obligation-shifting transaction and payments treated as being made to the property provider under the section 7701(l) note, the property provider is treated as a party to a loan (a ‘‘section 7701(l) rent-leveling loan’’). The section 7701(l) rent-leveling loan is created at the time of the obligation-shifting transaction. Its balance at that time equals the section 467 loan that would have existed if the property provider had been using the constant rental accrual method to account for amounts under the lease or similar agreement that are allocable to periods before the obligation-shifting transaction. Thus, in the periods after the obligation-shifting transaction, the property provider must account for any interest expense or income resulting from the section 7701(l) rent-leveling loan, in addition to any interest income or expense resulting from the section 7701(l) note.

Although section 467 may not apply to an obligation-shifting transaction, the effect of the proposed regulations is to recharacterize the transaction to produce the constant rental amount and associated loans that the parties would have been treated as having if the lease or similar agreement had been a section 467 rental agreement (modified to reflect the amounts already received or payable to the property provider immediately before the obligation-shifting transaction) and had been subject to the constant rental accrual method. Thus, the assuming party is treated as if it had purchased the property in part with a note, had obtained the right to receive rental amounts on the constant rental accrual method during its ownership of the property, and had used those amounts to service the note. For the property provider, the proposed regulations provide a recharacterization that is similar (but not identical) to the treatment required when a lessor disposes of property subject to a section 467 rental agreement that was accounted for under the constant rental accrual method.

The proposed regulations provide the exclusive recharacterization of an obligation-shifting transaction for a property provider and an assuming party. Thus, if an obligation-shifting transaction is recharacterized under this section and the lease or similar agreement is a section 467 rental agreement, the rules of this section supersede the rules of §§ 1.467–1 through 1.467–8 as proposed on June 3, 1996 (IA–292–84, 61 FR 27834) for the property provider (the transferor) and the assuming party (the transferee). The assuming party's income after the obligation-shifting transaction is determined under this section and not under § 1.467–7(e)(1). Similarly, the rules provided in § 1.467–7(e)(2) for determining the amount of the section 467 loan for the period after the transfer, the amount realized by the property provider, and the assuming party's basis in the property do not apply to obligation-shifting transactions recharacterized by this section.

The recharacterization does not affect the property user or rent factor (if any), because, even though they are parties to the multiple-party financing transaction, no adjustment to their treatment of the transaction is necessary to prevent the avoidance of tax. *Cf.* § 1.881–3(a)(3)(ii)(A) (limiting purposes for which conduit financing arrangements are recharacterized). Thus, if the lease or similar agreement is a section 467 rental agreement, the property user must continue to take section 467 rent and section 467 interest into account without regard to the obligation-shifting transaction and the recharacterization under this section. *See* § 1.467–7(e)(1).

6. Issues not addressed

The proposed regulations do not address transactions in which a taxpayer assigns rights to future income but does not transfer the underlying property to another taxpayer, except as provided in the special rules regarding pass-through entities and consolidated groups.

7. Proposed effective date

Notice 95–53 states that the regulations under section 7701(l) will be effective "with respect to stripping transactions any significant element of which is entered into or undertaken on or after October 13, 1995." The regulations are proposed to adopt the effective date stated in the notice.

Special Analyses

It is hereby certified that these regulations do not have a significant economic impact on a substantial number of small entities. This certification is based on the understanding of the IRS that the total number of entities engaging in transactions affected by these regulations is not substantial and, of those entities, most are not small entities within the meaning of the Regulatory Flexibility Act (5 U.S.C. chapter 6). Therefore, a Regulatory Flexibility Analysis is not required. It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in E.O. 12866. Therefore, a regulatory assessment is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comments on its impact on small businesses.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for April 29, 1997, at 10 a.m. in the IRS Auditorium, Internal Revenue Building, 7th Floor, 1111 Constitution Avenue NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments and submit an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by April 8, 1997.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Jonathan R. Zelnik, Office of the Assistant Chief Counsel (Financial Institutions & Products). However, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.7701(l)–2 also issued under 26 U.S.C. 7701(l). * * *

Par. 2. Section 1.7701(l)–1 is amended as follows:

1. Paragraphs (b)(6) and (b)(7) are revised.

2. Paragraph (b)(8) is added.

The revisions and addition reads as follows:

§ 1.7701(l)–1 Conduit financing arrangements.

* * * * *

(b) * * *

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(6) Section 1.6038A–3(b)(5);

(7) Section 1.6038A–3(c)(2)(vii); and

(8) Section 1.7701(l)–2.

Par. 3. Section 1.7701(l)–2 is added under the center heading "General Actuarial Valuations" to read as follows:

§ 1.7701(l)–2 Treatment of obligation-shifting transactions.

(a) *Purpose.* The purpose of this section is to prevent avoidance of tax by parties participating in multiple-party financing transactions that involve an assumption of obligations under a lease or similar agreement. This section should be interpreted in a manner consistent with this purpose.

(b) *In general.* Obligation-shifting transactions as defined in paragraph (h)(1) of this section are recharacterized in the manner described in paragraph (d) of this section unless an exception in paragraph (c) of this section applies.

(c) *Exceptions*—(1) *In general.* Paragraph (d) of this section does not apply if any of the following is satisfied:

(i) The aggregate amounts that have already been received by or are payable to the property provider but are allocable to periods (including partial periods) after the obligation-shifting transaction (as determined under paragraph (g) of this section) are less than or equal to $100,000.

(ii) The sum of the aggregate payments (including contingent payments) under the lease or similar agreement and the aggregate value of other consideration (including contingent consideration) to be received under the lease or similar agreement is not reasonably expected to exceed $250,000. The rules of § 1.467–1(c)(4)(ii)[1] apply in determining the amount described in this paragraph (c)(1)(ii).

(iii) The fair market value of the leased property is less than ten percent of the aggregate fair market value of all of the property (excluding Class I assets as described in § 1.1060–1T(d)(1), Class II assets as described in § 1.1060–1T(d)(2)(i), and debt issued by the property provider) that the property provider transfers to the assuming party as part of the same transaction or series of related transactions. For this purpose, the fair market value of the leased property is the sum of—

(A) The fair market value of the property subject to the lease or similar agreement and transferred in the obligation-shifting transaction, plus

(B) The value of the amounts that have already been received under the lease or similar agreement or are retained by the property provider or any other party but are allocable to periods (including partial periods) after the obligation-shifting transaction.

(iv) The agreement(s) between the property provider and the property user is a disqualified leaseback or long-term agreement within the meaning of § 1.467–3(b).[2]

(v) The transaction is described in section 381(a), unless the transaction is deemed to be an obligation-shifting transaction under paragraph (k) of this section.

(vi) The Commissioner determines that the transaction does not substantially reduce the present value of the tax liability of the assuming party or otherwise result in the avoidance of tax.

(2) *Limitation on exceptions.* The exceptions listed in paragraph (c)(1) of this section do not apply to obligation-shifting transactions entered into with a principal purpose of substantially reducing the present value of the aggregate tax liability of the assuming party, the property provider, and any person whose taxable income is determined (in whole or in part) by reference to the taxable income of the property provider or the assuming party.

(d) *Recharacterization of obligation-shifting transaction*—(1) *In general.* In order to clearly reflect the income of the assuming party and the property provider, an obligation-shifting transaction is recharacterized as follows:

(i) *Assuming party treated as receiving all allocable rents.* The assuming party is treated as acquiring the right to receive (and as receiving when due) all amounts under the lease or similar agreement that are allocable (as determined under paragraph (g) of this section) to periods (including partial periods) after the obligation-shifting transaction. Thus, the assuming party must include these amounts in income in the periods to which they are allocable.

(ii) *Assuming party treated as issuing section 7701(l) note.* The assuming party is treated as issuing to the property provider, as additional consideration in the obligation-shifting transaction, a section 7701(l) note, with terms as described in paragraph (e) of this section. Accordingly, the assuming party and the property provider must account for interest expense and income from the section 7701(l) note in the periods (including partial periods) following the obligation-shifting transaction.

(2) *Section 7701(l) rent-leveling loan and adjustment to property provider's income*—(i) *Section 7701(l) rent-leveling loan.* To account for any differences in timing or amount between payments actually received by the property provider after the obligation-shifting transaction and payments (as described in paragraph (e)(3) of this section) treated as being made under the section 7701(l) note, the property provider is treated as a party to a section 7701(l) rent-leveling loan, with terms as described in paragraph (f) of this section. Accordingly, the property provider must account for interest expense or income (as appropriate) in the periods (including partial periods) following the obligation-shifting transaction.

(ii) *Adjustment to property provider's income.* To account for any differences between amounts previously included by the property provider and amounts that are allocable to periods before the obligation-shifting transaction, on the date on which the obligation-shifting transaction is consummated, the property provider must treat as an item of expense or income (as appropriate)—

(A) The principal balance of the section 7701(l) rent-leveling loan, minus

(B) The principal balance (plus interest not already included in the principal balance) of the property provider's section 467 loan (if any) as determined under the principles of § 1.467–4(a)(4)[3] and existing as of that date.

(3) *Exclusive recharacterization.* If the lease or similar agreement is a section 467 rental agreement, the property provider and the assuming party must account for the recharacterized transaction under the provisions of this section and not under the provisions of §§ 1.467–1 through 1.467–8.[4]

(e) *Section 7701(l) note*—(1) *Principal.* On the date on which the obligation-shifting transaction is consummated, the principal balance of the section 7701(l) note equals the excess of—

(i) The present value of the amounts that are allocable to periods (including partial periods) after the obligation-shifting transaction, over

(ii) The present value of the amounts that are payable to the assuming party.

(2) *Present value, yield, and compounding period.* For purposes of paragraph (e)(1) of this section, present value is determined under the rules of § 1.467–2(d). The yield of the section 7701(l) note equals 110 percent of the applicable Federal rate on the date on which the obligation-shifting transaction is consummated, based on the remaining term of the lease or similar agreement. The compounding period for determining both the original principal balance and the yield must equal the period used in determining the amounts that are allocable (as determined under paragraph (g) of this section) to periods under the lease or similar agreement.

(3) *Repayment schedule*—(i) *Amount.* The payment for each period under the section 7701(l) note is—

(A) The amount that is taken into account by the assuming party under paragraph (d)(1)(i) of this section, minus

[1]This section appears in proposed regulations published on June 3, 1996 (IA–292–84, 61 FR 27834, 27839).

[2]This section appears in proposed regulations published on June 3, 1996 (IA–292–84, 61 FR 27834, 27844).

[3]This section appears in proposed regulation published on June 3, 1996 (IA–292–84, 61 FR 27834, 27845).

[4]These sections appear in proposed regulations published on June 3, 1996 (IA–292–84, 61 FR 27834).

[5]This section appears in proposed regulations published on June 3, 1996 (IA–292–84, 61 FR 27834, 27842).

(B) The amount received by the assuming party for that period.

(ii) *Timing.* The timing of section 7701(l) note payments, as determined under paragraph (e)(3)(i) of this section, is the same as the timing of the payments taken into account by the assuming party under paragraph (d)(1)(i) of this section.

(4) *Debt for all purposes.* A section 7701(l) note is debt for all purposes of the Internal Revenue Code. The principal balance of the section 7701(l) note after the obligation-shifting transaction may be positive or negative. If the principal balance is positive, the note represents an amount owed by the assuming party to the property provider, and if the principal balance is negative, the note represents an amount owed by the property provider to the assuming party.

(f) *Section 7701(l) rent-leveling loan*—(1) *Principal.* On the date on which the obligation-shifting transaction is consummated, the principal balance of the section 7701(l) rent-leveling loan equals the principal balance (plus any interest not already included in the principal balance) of the section 467 loan as determined under § 1.467–4(b) that would have existed as of that date if—

(i) The amounts payable under the lease or similar agreement were the amounts described in paragraphs (g)(1) and (g)(2) of this section, and

(ii) The property provider had reported all items of income and expense with respect to the lease or similar agreement by applying the constant rental accrual method described in § 1.467–3(d) and by determining the section 467 rent for each period in accordance with § 1.467–1(d)(2)(i).

(2) *Yield and compounding period.* The yield of the section 7701(l) rent-leveling loan equals 110 percent of the applicable Federal rate on the date on which the obligation-shifting transaction is consummated, based on the original term of the lease or similar agreement. The compounding period for determining the yield must equal the period used in determining the amounts that are allocable (as determined under paragraph (g) of this section) to periods under the lease or similar agreement.

(3) *Repayment schedule*—(i) *Amount.* The property provider's payment (or receipt) for each period under the section 7701(l) rent-leveling loan is—

(A) The amount (as described in paragraph (e)(3)(i) of this section) treated as paid in satisfaction of the section 7701(l) note, minus

(B) The amount received by the property provider under the lease or similar agreement for that period.

(ii) *Timing.* The timing of section 7701(l) rent-leveling loan payments, as determined under paragraph (f)(3)(i) of this section, is governed by paragraph (g) of this section (and thus, is the same as the timing of the payments taken into account by the assuming party under paragraph (d)(1)(i) of this section).

(4) *Debt for all purposes.* A section 7701(l) rent-leveling loan is debt for all purposes of the Internal Revenue Code. The principal balance of the section 7701(l) rent-leveling loan may be positive or negative. If the principal balance is positive, the amount represents a loan on which the property provider is the obligee, and if the principal balance is negative, the amount represents a loan on which the property provider is the obligor.

(g) *Determining amounts that are allocable to periods under the lease or similar agreement.* The amounts that are allocable to periods under a lease or similar agreement are determined (immediately before the obligation-shifting transaction is consummated) by applying the constant rental accrual method described in § 1.467–3(d) from the inception of the lease or similar agreement based on—

(1) The amounts that have already been received under the lease or similar agreement, and

(2) The amounts that are payable under the lease or similar agreement.

(h) *Definitions.* The following definitions apply solely for purposes of this section.

(1) An *obligation-shifting transaction* is any transaction in which an assuming party assumes a property provider's obligations to a property user (or acquires property subject to a property provider's obligations to a property user) under a lease or similar agreement if the property provider or any other party has already received, or retains the right to receive, amounts that are allocable to periods after the transaction.

(2) A *property user* is any person with the right to use property under a lease or similar agreement.

(3) A *property provider* is any person (other than an assuming party in its capacity as such) that is obligated to make property available to a property user on account of a lease or similar agreement.

(4) An *assuming party* is any person that assumes obligations or acquires property subject to obligations under an existing lease or similar agreement with a property user.

(5) A *lease or similar agreement* is any contract for the use or enjoyment of tangible or intangible property, including leaseholds, licenses, other non-fee interests in property, and other contracts (including service contracts) involving the use or enjoyment of property if the fair market value of that use or enjoyment is more than de minimis.

(6) *Obligations under a lease or similar agreement* include the continuing obligation to make property subject to a lease or similar agreement available to a property user. To the extent that an assuming party assumes obligations of a property provider or acquires property subject to obligations of a property provider, the obligations shall not thereafter be treated as obligations of the property provider.

(7) *Amounts that have already been received under the lease or similar agreement* include consideration received (as of the date on which the obligation-shifting transaction is consummated) for assigning the rights to receive payments under the lease or similar agreement.

(8) *Amounts that are payable under the lease or similar agreement* do not include payments the rights to which have been assigned in an arm's-length transaction to an unrelated third person in exchange for consideration.

(9) A *section 7701(l) note* is indebtedness arising from the recharacterization described in paragraph (d)(1)(ii) of this section. The terms of a section 7701(l) note are described in paragraph (e) of this section.

(10) A *section 7701(l) rent-leveling loan* is indebtedness arising from the recharacterization described in paragraph (d)(2)(i) of this section. The terms of a section 7701(l) rent-leveling loan are described in paragraph (f) of this section.

(i) *Reserved.*

(j) *Pass-through entity look-through rule*. For purposes of determining whether any person is a property user, a property provider, or an assuming party, the person is treated as having the rights and obligations of any pass-through entity in which the person is a partner, shareholder, beneficiary, or other participant, but only to the extent of the person's allocable share of pass-through entity items relating to the property. The pass-through entity must reflect the required recharacterization on its books.

(k) *Consolidated group rule.* For purposes of this section, if a subsidiary is a member of a consolidated group and the subsidiary or a successor becomes a nonmember (other than in a transaction described in § 1.1502–13(j)(5)), the nonmember (whether or not a separate legal entity) will be treated as a separate corporation that acquires the assets and assumes the obligations of the subsidiary. For example, assume that P sells all the stock of S, previously a wholly-owned subsidiary of P and a member of the P consolidated group, and that, at the time of the sale, S already has received amounts under a lease that are allocable to periods after the sale. Under this paragraph (k), an obligation-shifting transaction occurs when S becomes a nonmember. S, as a nonmember, is treated as having assumed the obligations under the lease. Therefore, S must adjust its income as provided in paragraph (d)(2)(ii) of this section immediately before it becomes a nonmember of the consolidated group. After the sale, S is treated as both a property provider and an assuming party in the obligation-shifting transaction.

(l) *Reserved.*

(m) *Examples.* The following examples illustrate the rules of this section. Each example assumes that all taxpayers use the calendar year as the taxable year, all payment periods are the calendar year, and none of the rental agreements are disqualified leasebacks or long-term agreements under § 1.467–3(b). Except as otherwise provided, none of the exceptions in paragraph (c)(1) of this section apply. The examples read as follows:

Example 1. Retained rents; section 351 transfer—(i) *Facts.* (A) On January 1, 2001, A leases property to B for a five-year period. The lease provides for rent of $10,000,000 per year, payable annually on December 31.

(B) On January 1, 2002, A transfers the leased property to D in exchange for D preferred stock. A retains the right to receive the remaining four years of rent from B. As part of the same transaction, C transfers $100,000,000 to D in exchange for D common stock. After the transaction, A and C own 100 percent of the stock of D. Assume the transaction meets all of the requirements of section 351. C and D are members of the same consolidated group as defined in § 1.1502–1(h). One hundred ten percent of the applicable Federal rate based on annual compounding is 7 percent.

(ii) *Obligation-shifting transaction.* B is a property user because B has the right to use the property under the lease with A. A is a property provider because A is obligated to make the property available to B on account of the lease. D is an assuming party because in the January 1, 2002, transaction D acquires the property subject to A's obligations under the lease to make the property available to B for the remaining four years of the lease. The transaction is an obligation-shifting transaction because D is an assuming party and A retains the right to receive rent from B allocable to periods after the transaction.

(iii) *Recharacterization.* As of January 1, 2002, the transaction is recharacterized as follows:

(A) Under the constant rental accrual method described in § 1.467–3(d), the amount accruing for each calendar year period under the lease is $10,000,000. D is treated as acquiring the right to receive the amounts allocable to the four periods after the obligation-shifting transaction. Thus, in 2002, 2003, 2004, and 2005, D must recognize $10,000,000 rental income.

(B) The principal balance of the section 7701(l) note equals $33,872,112.56, with a yield equal to 7 percent based on annual compounding. As part of the obligation-shifting transaction, D is treated as having given A the section 7701(l) note as additional consideration. The amount of the section 7701(l) note is treated as ''other property'' transferred from D to A in the section 351 exchange. D is treated as making section 7701(l) note payments to A. A has interest income on the section 7701(l) note. D has interest expense on the section 7701(l) note. A and D account for the section 7701(l) note as follows:

Section 7701(l) note

Taxable year ending	*Beginning balance*	*Payment*	*Interest*	*Principal*
12/31/02	$33,872,112.56	$10,000,000.00	$2,371,047.88	$7,628,952.12
12/31/03	$26,243,160.44	$10,000,000.00	$1,837,021.23	$8,162,978.77
12/31/04	$18,080,181.67	$10,000,000.00	$1,265,612.72	$8,734,387.28
12/31/05	$ 9,345,794.39	$10,000,000.00	$ 654,205.61	$9,345,794.39

(C) Because the amount A recognized in the year before the obligation-shifting transaction equals the amount A would have recognized under the constant rental accrual method, A's adjustment to income on the consummation of the obligation-shifting transaction is $0.

(D) At the time of the obligation-shifting transaction, the principal balance of the section 7701(l) rent-leveling loan equals $0. Furthermore, because the amounts A actually receives each year after the obligation-shifting transaction, $10,000,000, equal the amounts D is treated as paying A under the section 7701(l) note, $10,000,000, the balance of the section 7701(l) rent-leveling loan equals $0 for all periods after the obligation-shifting transaction. Thus, A has no interest income or expense arising from the section 7701(l) rent-leveling loan.

Example 2. Rents already received; section 351 transfer—(i) Facts. (A) On January 1, 2001, X leases property to Y for a seven-year period. The XY lease provides for rent of $900,000 per year, payable annually on December 31. Also on January 1, 2001, Y leases the property to Z for a five-year period. The YZ lease provides for rent payable on December 31 of each year as follows: $800,000 in 2001, $900,000 in 2002, $1,000,000 in 2003, $1,100,000 in 2004, and $1,200,000 in 2005.

(B) On December 31, 2001, Y sells to F the right to receive all rents from Z for 2002 through 2005. F pays Y $3,146,345.27. Y includes the $3,146,345.27 as ordinary income.

(C) On January 1, 2002, Y contributes to S cash of $2,500,000, Y's rights and obligations under the lease with X, and Y's rights and obligations under the lease with Z in exchange for S preferred stock. As part of the same transaction, P transfers cash of $7,500,000 to S in exchange for S common stock. After the transaction, Y and P own 100 percent of the stock of S. Assume the transaction meets all of the requirements of section 351. S and P are members of the same consolidated group as defined in § 1.1502–1(h). One hundred ten percent of the applicable Federal rate based on annual compounding is 10 percent.

(ii) *Obligation-shifting transaction.* Z is a property user because Z has the right to use the property under the YZ lease. Y is a property provider because Y is obligated to make the property available to Z. S is an assuming party because in the January 1, 2002, transaction, S assumes Y's obligations under the YZ lease to make the property available for the remaining four years of the lease. The transaction is an obligation-shifting transaction because S is an assuming party and Y has already received amounts allocable to periods after the transaction (Y sold to F the right to receive rent payments under the YZ lease for 2002 through 2005).

(iii) *Recharacterization.* As of January 1, 2002, the transaction is recharacterized as follows:

(A) Under the constant rental accrual method described in § 1.467–3(d), the amount accruing for each calendar year period under the YZ lease is $946,396.31, based on the $800,000 Y received from Z on December 31, 2001, and the $3,146,345.27 Y received from F on December 31, 2001. S is treated as acquiring the right to receive the amounts allocable to the four periods after the obligation-shifting transaction. Thus, S must recognize $946,396.31 of rental income for each of the four periods following the obligation-shifting transaction.

(B) The principal balance of the section 7701(l) note equals $2,999,948.96, with a yield equal to 10 percent based on annual compounding. As part of the obligation-shifting transaction, S is treated as having given Y the section 7701(l) note as additional consideration. The amount of the section 7701(l) note is treated as ''other property'' transferred from S to Y in the section 351 exchange. S is treated as making section 7701(l) note payments to Y. Y has interest income on the section 7701(l) note. S has interest expense on the section 7701(l) note. S and Y account for the section 7701(l) note as follows:

Section 7701(l) note

Taxable year ending	*Beginning balance*	*Payment*	*Interest*	*Principal*
12/31/02	$2,999,948.96	$946,396.31	$299,994.90	$646,401.41
12/31/03	$2,353,547.55	$946,396.31	$235,354.75	$711,041.56
12/31/04	$1,642,505.99	$946,396.31	$164,250.60	$782,145.71
12/31/05	$ 860,360.28	$946,396.31	$ 86,036.03	$860,360.28

(C) At the time of the obligation-shifting transaction, the principal balance of the section 467 loan that would have existed if Y had reported all items of income and expense by applying the constant rental accrual method equals negative $2,999,948.96. Thus, in computing its income on the consummation of the obligation-shifting transaction, Y must take into account an expense equal to $2,999,948.96.

(D) At the time of the obligation-shifting transaction, the principal balance of the section 7701(l) rent-leveling loan equals negative $2,999,948.96. Y must account for the section 7701(l) rent-leveling loan as follows:

Section 7701(l) rent-leveling loan

Taxable year ending	*Beginning balance*	*Payment*	*Interest*	*Principal*
12/31/02	($2,999,948.96)	($946,396.31)	($299,994.90)	($646,401.41)
12/31/03	($2,353,547.55)	($946,396.31)	($235,354.75)	($711,041.56)
12/31/04	($1,642,505.99)	($946,396.31)	($164,250.60)	($782,145.71)
12/31/05	($ 860,360.28)	($946,396.31)	($ 86,036.03)	($860,360.28)

Example 3. Rents already received; sale of a partnership interest—(i) *Facts.* (A) On January 1, 2001, A, B, and C form partnership PRS by contributing $3,600,000, $396,000, and $4,000, respectively, for proportionate interests (90.0 percent, 9.9 percent, and 0.1 percent, respectively) in the capital and profits of PRS. On the same day, PRS purchases property for $4,000,000 and leases the property to X for a five-year period. The lease provides for rent payable on December 31 of each year as follows: $800,000 in 2001, $900,000 in 2002, $1,000,000 in 2003, $1,100,000 in 2004, and $1,200,000 in 2005.

(B) On December 31, 2001, PRS sells to F the right to receive all rents from X for 2002 through 2005. F pays PRS $3,146,345.27. PRS treats the $3,146,345.27 as ordinary income allocated $2,831,710.74 to A, $311,488.18 to B, and $3,146.35 to C. One hundred ten percent of the applicable Federal rate based on annual compounding is 10 percent.

(C) Immediately following the sale of the rents, A sells its entire partnership interest to D based on the fair market value of 90 percent of PRS's assets. PRS does not have an election in effect under section 754.

(ii) *Obligation-shifting transaction.* X is a property user because X has the right to use the property under the lease with PRS. A is a property provider as to its share of the partnership's obligations under the lease to make the property available to X. D is an assuming party because D acquires A's partnership interest subject to A's share of the partnership's obligations under the lease with X to make the property available for the remaining four years of the agreement. The transaction is an obligation-shifting transaction because D is an assuming party and A has already received income allocable to periods after the transaction (A received allocations of income from the sale of the right to receive rents under the lease in 2002 through 2005). Thus, D is treated as assuming 90 percent of the partnership's obligations under the lease.

(iii) *Recharacterization.* As of January 1, 2002, the transaction is recharacterized as follows:

(A) Under the constant rental accrual method described in § 1.467–3(d), the amount accruing for each calendar year period under the lease is $946,396.31, based on the $800,000 PRS received from X and the $3,146,345.27 PRS received from F. A's share of the amount payable in each calendar year period under the lease is $851,756.68 (90 percent of $946,396.31). D is treated as acquiring the right to A's 90 percent share of the amounts allocable to the four periods after the obligation-shifting transaction. Thus, D must recognize $851,756.68 of rental income for each of the four periods following the obligation-shifting transaction.

(B) The principal balance of the section 7701(l) note equals $2,699,954.06, with a yield equal to 10 percent based on annual compounding. As part of the obligation-shifting transaction, D is treated as having given A the section 7701(l) note as additional consideration. D is treated as making section 7701(l) note payments to A. A has interest income on the section 7701(l) note. D has interest expense on the section 7701(l) note. A and D account for the section 7701(l) note as follows:

Section 7701(l) note

Taxable year ending	*Beginning balance*	*Payment*	*Interest*	*Principal*
12/31/02	$2,699,954.06	$851,756.68	$269,995.41	$581,761.27
12/31/03	$2,118,192.79	$851,756.68	$211,819.28	$639,937.40
12/31/04	$1,478,255.39	$851,756.68	$147,825.54	$703,931.14
12/31/05	$ 774,324.25	$851,756.68	$ 77,432.42	$774,324.26

(C) At the time of the obligation-shifting transaction, the principal balance of the section 467 loan that would have existed if PRS had reported all items of income and expense by applying the constant rental accrual method equals negative $2,999,948.96. Thus, in computing its income on the consummation of the obligation-shifting transaction, A must take into account an expense equal to $2,699,954.06 (90 percent of $2,999,948.96).

(D) At the time of the obligation shifting transaction, the principal balance of the section 7701(l) rent-leveling loan equals negative $2,699,954.06. A must account for the section 7701(l) rent-leveling loan as follows:

Section 7701(l) rent-leveling loan

Taxable year ending	Beginning balance	Payment	Interest	Principal
12/31/02	($2,699,954.06)	($851,756.68)	($269,995.41)	($581,761.27)
12/31/03	($2,118,192.79)	($851,756.68)	($211,819.28)	($639,937.40)
12/31/04	($1,478,255.39)	($851,756.68)	($147,825.54)	($703,931.14)
12/31/05	($ 774,324.25)	($851,756.68)	($ 77,432.42)	($774,324.26)

Example 4. Exception where aggregate amounts retained or already received are less than or equal to $100,000; section 351 transfer—(i) *Facts.* (A) On January 1, 2001, A leases property to B for a five-year period. The lease provides for rent of $1,000,000 for 2001, and $875,000 for the each of the remaining four years of the lease. Rent is payable annually on December 31.

(B) On January 1, 2002, A transfers the leased property along with the right to receive rent payments for 2002 through 2005 to D in exchange for D preferred stock. As part of the same transaction, C transfers $1,000,000 to D in exchange for D common stock. After the transaction, A and C own 100 percent of the stock of D. Assume that the transaction meets all of the requirements of section 351. C and D are members of the same consolidated group as described in § 1.1502–1(h). Assume that A, C, and D did not enter into the transaction with a principal purpose of substantially reducing the present value of their aggregate tax liabilities. One hundred ten percent of the applicable Federal rate based on annual compounding is 7 percent.

(ii) *Obligation-shifting transaction.* A is a property provider because it is obligated to make property available to B on account of a lease or similar agreement. B is a property user because it has the right to use property under its lease with A. D is an assuming party because, in the January 1, 2002, transaction, it acquires the property subject to A's obligation to make the property available to B for the remaining term of the lease. The transaction between A and D is an obligation-shifting transaction because D is an assuming party and A retains the right to receive amounts from B allocable to periods after the transaction.

(iii) *Availability of exception.* Even though the transaction between A and D is an obligation-shifting transaction, it is not recharacterized under this section. As of the date of the transaction, A has already received $1,000,000. Under the constant rental accrual method described in § 1.467–3(d), the constant rental amount accruing for each calendar year during the lease is $903,491.90. The aggregate amount that has already been received by A but that is allocable to periods after the obligation-shifting transaction is $1,000,000 minus $903,491.90, or $96,508.10. Because this amount is less than $100,000, the transaction is excepted from recharacterization under paragraph (c)(1)(i) of this section.

Example 5. Exception where fair market value of leased property is less than 10 percent of value of all property transferred; incorporation of existing business—(i) *Facts.* (A) On January 1, 2001, A leases property to B for a five-year period. The lease provides for rent of $1,000,000 per year, payable annually on December 31.

(B) On January 1, 2003, the fair market value of the leased property is $4,000,000. On that date, A transfers the property, together with $3,000,000 of Class I and Class II assets and other property with a fair market value of $39,000,000, in exchange for all of the common stock of C. A retains the right to receive the remaining three rent payments from B. The fair market value of the rent payments retained by A is $2,486,851.99 (based on a discount rate of 10 percent). The fair market value of the property subject to the lease and transferred to B, reflecting A's retention of the right to the remaining three rent payments, is $1,513,148.01. Assume that the transaction meets all of the requirements of section 351. Assume that A and C did not enter into the transaction with a principal purpose of substantially reducing the present value of their aggregate tax liabilities.

(ii) *Obligation-shifting transaction.* A is a property provider because it is obligated to make property available to B on account of a lease or similar agreement. B is a property user because it has the right to use property under its lease with A. C is an assuming party because, in the January 1, 2003, transaction, it acquires the property subject to A's obligation to make the property available to B for the remaining three years of the lease. The transaction between A and C is an obligation-shifting transaction because C is an assuming party and A retains the right to receive amounts from B allocable to periods after the transaction.

(iii) *Availability of exception.* Even though the transaction between A and C is an obligation-shifting transaction, it is not recharacterized under this section. The fair market value of the leased property equals $4,000,000. The fair market value of the property subject to the lease and transferred to B is $1,513,148.01, and the fair market value of the rents retained is $2,486,851.99. The aggregate fair market value of all of the property transferred, excluding Class I assets, Class II assets, and debt issued by the property provider, as part of the same transaction is $43,000,000 ($4,000,000 leased property plus $39,000,000 other property, excluding Class I assets, Class II assets, and debt issued by the property provider). Because the value of the leased property, $4,000,000, is less than 10 percent of $43,000,000, the transaction is excepted from recharacterization under paragraph (c)(1)(iii) of this section.

(n) *Effective date.* This section applies to obligation-shifting transactions any significant element of which was entered into or undertaken on or after October 13, 1995.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on December 26, 1996, 8:45 a.m., and published in the issue of the Federal Register for December 27, 1996, 61 F.R. 68175)

Notice of Proposed Rulemaking and Notice of Public Hearing

Reorganizations; Receipt of Securities

REG–249819–96

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the receipt, as part of a reorganization, of rights to acquire stock of a corporation that is a party to the reorganization. This document also provides notice of a public hearing on these regulations.

DATES: Written comments must be received by March 23, 1997. Requests to appear and outlines of topics to be discussed at the public hearing scheduled for March 25, 1997, must be received by March 4, 1997.

ADDRESSES: Send submissions to: CC:DOM:CORP:R [REG–249819–96], room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R [REG–249819–96], Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC, or, electronically, via the IRS Internet site at: http://www.irs.ustreas.gov/prod/tax_regs/comments.html.

The public hearing will be held in the Commissioner's Conference Room, room 3313, 1111 Constitution Avenue NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Michael J. Danbury, (202) 622–7750; concerning submissions and the public hearing, Evangelista Lee at (202) 622–7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

A. General information

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under sections 354, 355, and 356 of the Internal Revenue Code of 1986 (Code), relating to exchanges of stock and securities in certain reorganizations. In particular, the proposed regulations address the receipt, as part of a reorganization, of rights to acquire stock of a corporation that is a party to the reorganization.

Section 354 generally provides for the nonrecognition of gain or loss from the exchange of stock or securities in a corporation that is a party to a reorganization for stock or securities in the same corporation or in another corporation that is a party to the reorganization. Gain realized on an exchange of securities is not recognized provided that the principal amount of the securities received does not exceed the principal amount of any securities surrendered pursuant to the plan of reorganization.

Section 355 provides for the nonrecognition of gain or loss upon a distribution by a corporation with respect to its stock of stock in a controlled corporation, or an exchange of securities in a controlled corporation for its securities. As in the case of a transaction described in section 354, gain realized on an exchange of securities is not recognized provided that the principal amount of the securities received does not exceed the principal amount of the securities surrendered pursuant to the plan of reorganization.

Section 356 provides rules for recognition of gain, but not loss, if a shareholder or security holder receives nonqualifying property (i.e., boot) as well as qualifying property in a transaction to which section 354 or 355 would otherwise apply. In particular, realized gain is recognized in an amount not in excess of the fair market value of the excess principal amount of the securities received over the principal amount of any securities surrendered as part of the plan of reorganization.

B. Existing regulations

Existing regulations under sections 354 and 355 provide that stock rights and stock warrants are not included in the term ''stock or securities.'' Prior to the promulgation of these regulations in 1955, the treatment of such instruments was unclear. Although the Supreme Court had held that stock warrants do not constitute ''stock'' for purposes of determining whether a transaction is a reorganization, the Board of Tax Appeals had held that stock warrants did constitute ''securities'' for purposes of section 112(b)(3) of the 1932 Act (a predecessor to section 354 of the Code). Compare *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194 (1942), with *Raymond v. Commissioner*, 37 B.T.A. 423 (1938).

Since 1955, courts have avoided concluding whether stock rights or stock warrants constitute ''securities'' for purposes of sections 354 and 355. See, e.g., *Carlberg v. United States*, 281 F.2d 507, 509 n.3 (8th Cir. 1960); *Bateman v. Commissioner*, 40 T.C. 408 (1963); *Estate of Smith v. Commissioner*, 63 T.C. 722 (1975).

C. Reasons for Change

A purpose of the reorganization provisions of the Code is to defer the recognition of gain and loss in certain readjustments of corporate structure. Generally, the Code extends nonrecognition to an exchange of stock which effects only a readjustment of continuing interest in modified corporate form. Although a right to acquire stock is not stock, the IRS and Treasury believe that it may generally represent a form of investment in the capital structure of the corporation that justifies nonrecognition treatment as a security under sections 354 and 355. Other provisions of the Code expressly acknowledge the role that stock rights play in the capital structure of a corporation. See, e.g., sections 317 and 1032. Accordingly, the proposed regulations provide that for purposes of sections 354 and 355 the term securities includes ''rights to acquire stock'' issued by a corporation that is a party to a reorganization.

Explanation of Provisions

A. Scope of proposed rules

The proposed regulations treat rights to acquire stock issued by a corporation that is a party to a reorganization as securities of the corporation. For this purpose, the term ''rights to acquire stock'' of an issuing corporation has the same meaning as the term has in sections 305(d)(1) and 317(a). It does not include rights exercisable against persons other than the issuer of the stock, or rights that relate to property other than stock of the issuer of the rights. As under current law, a conversion privilege contained in a stock or debt instrument generally will not be considered a separate property right received as part of the reorganization. See Rev. Rul. 69–265 (1969–1 C.B. 109).

B. Consequences upon receipt of stock rights

For purposes of sections 354, 355 and 356, the proposed regulations treat rights to acquire stock as securities having no principal amount. As a result, a taxpayer will not be required to recognize any gain under section 356 upon the receipt of a stock right. This will generally be the case regardless of whether the taxpayer surrenders stock, stock rights, or debt securities.

C. Effect on other authorities

The proposed rules apply only for the purpose of determining the amount of gain to be recognized in connection with exchanges occurring pursuant to transactions otherwise qualifying under section 368 or 355. They do not address issues concerning the qualification of a transaction under section 368 or 355. For example, the proposed rules do not permit rights to acquire stock to be taken into account in determining continuity of shareholder interest. See *Southwest Consolidated Corp.* (stock options are not stock).

The proposed rules have no effect on other Code provisions governing the treatment of stock options or similar interests for other purposes. Thus, for example, the treatment of an instrument under these rules is not relevant in determining whether the holder of the instrument is treated as holding stock of the issuer for various purposes. See, e.g., sections 318(a)(4), 382(k)(6), and 1504(a)(5). Similarly, an instrument treated as a stock right under these rules may be subject to special rules under other provisions of the Code or regulations relating to compensation related stock options. See, e.g., sections 83 and 421–424 and the regulations thereunder. Nor is any inference intended as to the treatment of an exchange, substitution, or assumption of such options under current law.

D. Proposed effective dates

The proposed regulations change a long-standing regulatory position. To afford taxpayers the opportunity to plan for the change, these regulations are proposed to be effective 60 days after the Treasury decision adopting these rules as final regulations is filed with the Office of the **Federal Register.**

E. Comments regarding need for further guidance

Comments are requested as to whether additional guidance is needed with respect to the scope of these regulations and the general treatment of rights to acquire stock. For example, comments are invited with respect to: the need for additional guidance or special rules to address transactions involving exchanges, substitutions, or assumptions of compensation related stock options; the application of section 306 to the transfer of a right to acquire common stock if the right is received tax-free pursuant to section 305 or 354; whether section 302 should apply to the cash settlement or repurchase of a stock right, for example by treating the holder as having purchased the stock pursuant to the terms of the right and the issuer as having then redeemed that stock for cash; and any other administrative guidance which may be helpful in light of these proposed rules, including suggestions as to existing revenue rulings or revenue procedures that should be modified, reconsidered, or revoked. Note that comments outside of the scope of these regulations will be considered as suggestions for other future guidance.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. Because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments submitted timely (in the manner described under the ADDRESSES caption) to the IRS. All comments will be available for public inspection and copying.

A public hearing is scheduled for March 25, 1997, at 10 a.m., in the Commissioner's Conference Room, room 3313. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit an outline of the topics to be discussed by March 4, 1997.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is David B. Friedel, formerly of the Office of Assistant Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par 2. Section 1.354–1 is amended by revising paragraph (e) to read as follows:

§ 1.354–1 Exchanges of stock and securities in certain reorganizations.

* * * * *

(e) For purposes of section 354, the term *securities* includes rights issued by a party to the reorganization (the *issuing corporation*) to acquire its stock. For purposes of this section and section 356(d)(2)(B), a right to acquire stock has no principal amount. This paragraph (e) applies to exchanges occurring on or after the day that is 60 days after the Treasury decision adopting these regulations is filed with the **Federal Register.**

Par 3. Section 1.355–1 is amended by removing the last sentence of paragraph (b) and adding paragraph (c) to read as follows:

§ 1.355–1 Distribution of stock and securities of a controlled corporation.

* * * * *

(c) *Stock rights.* For purposes of section 355, the term *securities* includes rights to acquire the stock of the distributing corporation or the controlled corporation (the *issuing corporation*). For purposes of this section and section 356(d)(2)(B), a right to acquire stock has no principal amount. This paragraph (c) applies to distributions occurring on or after the day that is 60 days after the Treasury decision adopting these regulations is filed with the **Federal Register.**

Par 4. Section 1.356–3 is amended by:

1. Redesignating existing paragraph (b) as paragraph (c).

2. Adding a new paragraph (b) to read as follows:

§ 1.356–3 Rules for treatment of securities as "other property".

* * * * *

(b) For purposes of this section, a right to acquire stock of the issuing corporation is treated as a security with no principal amount. Thus, such right is not *other property* when received in a transaction to which section 356 applies (regardless of whether securities are surrendered in the exchange). This paragraph (b) applies to transactions occurring on or after the day that is 60 days after the Treasury decision adopting these regulations is filed with the Federal Register.

* * * * *

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on December 20, 1996, 8:45 a.m., and published in the issue of the Federal Register for December 23, 1996, 61 F.R. 67508)

Notice of Proposed Rulemaking and Notice of Public Hearing

Continuity of Interest

REG–252231–96

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations providing that the continuity of shareholder interest requirement for corporate reorganizations is satisfied if the acquiring corporation

furnishes consideration which represents a proprietary interest in the affairs of the acquiring corporation and such consideration represents a substantial part of the value of the stock or properties transferred. Dispositions of stock of the acquiring corporation by a former target shareholder generally are not taken into account in determining whether continuity of shareholder interest has been satisfied. This document also provides notice of a public hearing on these proposed regulations.

DATES: Comments must be received by March 24, 1997. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for Wednesday, May 7, 1997 must be received by Wednesday, April 16, 1997.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–252231–96), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (REG–252231–96), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the ''Tax Regs'' option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Phoebe Bennett, (202) 622–7750; concerning submissions and the hearing, Christina Vasquez, (202) 622–6808 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under section 368. The proposed regulations provide that the continuity of shareholder interest (COSI) requirement is satisfied if the acquiring corporation furnishes consideration which represents a proprietary interest in the affairs of the acquiring corporation and such consideration represents a substantial part of the value of the stock or properties transferred.

Background

The Internal Revenue Code of 1986 (Code) provides general nonrecognition treatment for reorganizations specifically described in section 368 of the Code. Literal compliance with the statutory requirements is not sufficient for nonrecognition. For example, to qualify as a reorganization the COSI requirement must also be satisfied.

The early statutory definitions of reorganizations did not specify the type of consideration required for a transaction to qualify as a reorganization. As a result, a transaction may have satisfied the literal definition of a reorganization even if the transaction resembled a sale. To prevent such transactions from qualifying as reorganizations, the COSI requirement was established by the courts to ensure that the consideration furnished by the acquiring corporation represented a proprietary interest in the affairs of the acquiring corporation and that such consideration represented a substantial part of the value of the stock or properties transferred. See *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935); *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933); *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937 (2d Cir. 1932), cert. denied 288 U.S. 599 (1933). ''Reorganization, merger and consolidation are words indicating corporate readjustments of existing interests. They all differ fundamentally from a sale where the vendor corporation parts with its interest for cash and receives nothing more.'' *Cortland*, 60 F.2d at 939.

The cases that gave rise to the COSI requirement did not involve situations in which shareholders of the target corporation disposed of stock consideration from the acquiring corporation after having received it. In those cases, the relevant inquiry was whether the acquiring corporation furnished the proper type of consideration in the reorganization. Over the years, issues have arisen regarding whether the COSI requirement is satisfied if the target shareholders, as contemplated at the time of the reorganization, subsequently dispose of the stock received from the acquiring corporation. Compare *McDonald's Restaurants of Illinois, Inc. v. Commissioner*, 688 F.2d 520 (7th Cir. 1982), rev'g *McDonald's of Zion v. Commissioner*, 76 T.C. 972 (1981), with *Penrod v. Commissioner*, 88 T.C. 1415 (1987). Various bar associations have asked the Treasury Department and the IRS to provide guidance to clarify existing law and reduce uncertainty in applying COSI principles in the context of postreorganization sales. See New York State Bar Association Tax Section, Postreorganization Continuity of Interest, reprinted in 73 Tax Notes 481 (1996); Committee on Taxation of Corporations of the Association of the Bar of the City of New York, Postreorganization Transactions and Continuity of Shareholder Interest, reprinted in 72 Tax Notes 1401 (1996).

Explanation of Proposed Regulations

The proposed regulations provide that the COSI requirement is satisfied if the acquiring corporation furnishes consideration in the reorganization that represents a proprietary interest in the affairs of the acquiring corporation and such consideration represents a substantial part of the value of the stock or properties transferred. Dispositions of stock of the acquiring corporation by a former target shareholder generally are not taken into account in determining whether COSI has been satisfied. However, the proposed regulations emphasize that all facts and circumstances must be considered in determining whether the acquiring corporation has in substance furnished the required consideration. For example, if the acquiring corporation or a related party (within the meaning of section 707(b)(1) or section 267(b) (without regard to section 267(e))) purchases the acquiring corporation stock shortly after the reorganization, all of the facts and circumstances may indicate that the transaction should be properly recast to treat the acquiring corporation as furnishing cash in the reorganization, in which case the reorganization would not satisfy the COSI requirement. This approach refocuses the COSI requirement on its initial purpose of ensuring that the acquiring corporation furnishes the proper type of consideration and also promotes simplicity and administrability in applying the COSI requirement.

Effect on Other Authorities

The proposed regulations do not specifically address the effect on COSI of dispositions of target stock before a transaction potentially qualifying as a reorganization. See, e.g., *King Enterprises, Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969); *J.E. Seagram Corp. v. Commissioner*, 104 T.C. 75 (1995); *Superior Coach of Florida, Inc. v. Com-*

missioner, 80 T.C. 895 (1983); *Yoc Heating Corp. v. Commissioner*, 61 T.C. 168 (1973). The Treasury Department and IRS are studying this question and also the role of the COSI requirement in section 368(a)(1)(D) reorganizations and section 355 transactions. See § 1.355–2(c). The Treasury Department and IRS solicit comments on these issues.

Effect on Other Documents

The IRS will modify or obsolete publications as necessary to conform with this regulation as of the date of publication in the **Federal Register** of the final regulations. See, e.g., Rev. Proc. 86–42 (1986–2 C.B. 722); Rev. Proc. 77–37 (1977–2 C.B. 568). The IRS solicits comments as to whether other publications should be modified or obsoleted.

Proposed Effective Date

The revisions and additions in the proposed regulations apply to transactions occurring after these regulations are published as final regulations in the **Federal Register**, except that they shall not apply to any transactions occurring pursuant to a written agreement which is (subject to customary conditions) binding on or before these regulations are published as final regulations in the **Federal Register.**

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight copies) or comments transmitted via Internet that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled at 10 a.m. on Wednesday, May 7, 1997, in the Auditorium, Internal Revenue Service, 1111 Constitution Avenue NW, Washington DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must request to speak by Wednesday, April 16, 1997, and submit an outline of the topics to be discussed and the time to be devoted to each topic by Wednesday, April 16, 1997.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Phoebe Bennett of the Office of the Assistant Chief Counsel (Corporate), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805. * * *

Par. 2. Section 1.368–1 is amended by:

1. Revising the third sentence of paragraph (b).

2. Adding two sentences between the fourth and fifth sentences of paragraph (b).

3. Adding paragraph (e).

The revisions and additions read as follows:

§ 1.368–1 Purpose and scope of exception of reorganization exchanges.

* * * * *

(b) * * * Requisite to a reorganization under the Code are a continuity of the business enterprise under the modified corporate form, and (except as provided in section 368(a)(1)(D)) a continuity of shareholder interest. * * * The continuity of shareholder interest requirement is described in paragraph (e) of this section. The third and fifth sentences of this paragraph apply to transactions occurring after these regulations are published as final regulations in the **Federal Register**, except that they shall not apply to any transactions occurring pursuant to a written agreement which is (subject to customary conditions) binding on or before these regulations are published as final regulations in the ***Federal Register***. * * *

* * * * *

(e) *Continuity of shareholder interest*—(1) *General rule.* The purpose of the continuity of shareholder interest requirement is to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available to corporate reorganizations. Continuity of shareholder interest requires that the acquiring corporation furnish consideration representing a proprietary interest in the affairs of the acquiring corporation and that such consideration represents a substantial part of the value of the stock or properties transferred. In determining whether the acquiring corporation has furnished such consideration, all facts and circumstances must be considered, including any plan or arrangement for the acquiring corporation or its successor corporation (or a person related to the acquiring corporation or its successor corporation within the meaning of section 707(b)(1) or section 267(b) (without regard to section 267(e))) to redeem or acquire the consideration provided in the reorganization. Thus, for example, if based on all the facts and circumstances the acquiring corporation has furnished solely cash, the continuity of shareholder interest requirement is not satisfied.

(2) *Triangular reorganizations.* For purposes of this paragraph (e), in the case of a triangular reorganization described in § 1.358–6(b), the continuity of shareholder interest requirement will be applied with reference to the stock of the corporation which is in control of the acquiring corporation (in a forward triangular merger) or in control of the merged corporation (in a reverse triangular merger).

(3) *Examples*. The following examples illustrate the application of this paragraph (e):

Example 1. A owns all of the stock of T. T merges into P. In the merger, A receives stock of P having a fair market value of $50x and cash of $50x. Immediately after the merger, and pursuant to a preexisting binding contract negotiated by A, A sells all of the stock of P received by A in the merger to B, a party not related to P. The transaction satisfies the continuity of shareholder interest requirement because A received stock of P representing a substantial part of the value of the total consideration transferred in the acquisition.

Example 2. A owns 80 percent of the stock of T and none of the stock of P, which is widely held. T merges into P. In the merger, A receives stock of P. In addition, A obtains registration rights pursuant to an agreement with P to register the P stock and sells such stock shortly after the acquisition in the open market. The transaction satisfies the continuity of shareholder interest requirement.

Example 3. A owns 80 percent of the stock of T and none of the stock of P. T merges into P. In the merger, A receives stock of P. In addition, A arranges with an independent investment banker to hedge the risk of loss on the P stock received in the merger. Neither P nor a party related to P enters directly or indirectly into the hedging transaction. The transaction satisfies the continuity of shareholder interest requirement.

Example 4. A owns 80 percent of the stock of T and none of the stock of P. T merges into P. In the merger, A receives stock of P but with an agreement that it will be redeemed shortly by P. Pursuant to the agreement, shortly after the merger P redeems all of the stock of P received by A in the merger for cash. Under all of the facts and circumstances, the cash is treated as furnished by P in the merger, so that the merger does not satisfy the continuity of shareholder interest requirement. The result is the same if S, P's wholly owned subsidiary, buys all of the stock of P received by A in the merger for cash. The result is also the same if pursuant to a plan between P, its investment banker, and A, P's investment banker buys all of the stock of P received by A in the merger for cash and, shortly thereafter, P redeems the stock held by the investment banker for cash.

(4) *Effective date.* Paragraph (e) applies to transactions occurring after these regulations are published as final regulations in the **Federal Register**, except that it shall not apply to any transactions occurring pursuant to a written agreement which is (subject to customary conditions) binding on or before these regulations are published as final regulations in the **Federal Register.**

Par. 3. In § 1.368–2, paragraph (a) is amended by removing the second sentence and adding two new sentences in its place to read as follows:

§ 1.368–2 Definition of terms.

(a) * * * The term does not embrace the mere purchase by one corporation of the properties of another corporation. The preceding sentence applies to transactions occurring after these regulations are published as final regulations in the **Federal Register**, except that it shall not apply to any transactions occurring pursuant to a written agreement which is (subject to customary conditions) binding on or before these regulations are published as final regulations in the **Federal Register**. * * *

* * * * *

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on December 20, 1996, 8:45 a.m., and published in the issue of the Federal Register for December 23, 1996, 61 F.R. 67512)

Foundations Status of Certain Organizations

Announcement 97–12

The following organizations have failed to establish or have been unable to maintain their status as public charities or as operating foundations. Accordingly, grantors and contributors may not, after this date, rely on previous rulings or designations in the Cumulative List of Organizations (Publication 78), or on the presumption arising from the filing of notices under section 508(b) of the Code. This listing does *not* indicate that the organizations have lost their status as organizations described in section 501(c)(3), eligible to receive deductible contributions.

Former Public Charities. The following organizations (which have been treated as organizations that are not private foundations described in section 509(a) of the Code) are now classified as private foundations:

ACDASCO, Chicago IL
Advertising Professionals of Des Moines Scholarship Foundation, Des Moines, IA
American Dream Corporation, Des Moines, IA
American Variety Arts Foundation, Detroit, MI
Americas Choice Community, Clarinda, IA
Am Housing, Inc., Omaha, NE
Association of Active Emergency Med Tech of Clay, Vermillion, SD
Association of Disabled Americans Inc., Poplar Bluff, MO
Batavia Riverwalk Committee Inc., Wheaton, IL
Belle Fourche Historical Preservation Inc., Belle Fourche, SD
Black Health Care Coalition, Kansas City, MO
Blue Springs School of Economics Inc., Blue Springs, MO
Bonnie Lynn Acres Inc., Milwaukee, WI
Canyon Ferry Limnological Institute Inc., Helena, MT
Cardiff Giant Theater Company, Chicago, IL
Cates Goodfellow Housing, St. Louis, MO
Cat Tables Inc., Lebanon, MO
Change, Pontiac, IL
Children, Inc., Woodward, IA
Chippewa Valley Volunteer Center Inc., Eau Claire, WI
Christian Ministries of St. Louis Inc, Clayton, MO
Christian Mission of Pignon-Pella, Pella, IA
Clayton Historical Society, Clayton, MO
Coast to Coast Theatre Company LTD, Waukegan, IL
Community Support Systems Inc., Omaha, NE
Cozad Youth Center Inc., Cozad, NE
Crisis Intervention Shelter Service, Sturgis, SD
Eagles Rest Ministries, Bloomington, MN
Edina Public Schools French Immerson Parent Organization, Edina, MN
Financial Information & Service Center Inc., Green Bay, Green Bay, WI
Fresh Start Center Inc., Greenfield, WI
Friends of the Sugar River Inc., Belleville, WI
Fountain House-Milwaukee Inc., Milwaukee, WI
Fox Cities Marathon Inc., Appleton, WI
Gifts From the Heart Milwaukee Inc., Milwaukee, WI
Gopher Golf Booster Club Inc., Minneapolis, MN
Homer Civic Association, Winona, MN
Ken Petty Ministries, Benton, IL
Lake City Athletic Boosters Club Inc., Lake City, MN
Lambda Justice Center, Minneapolis, MN
Latino Sports Association of Wisconsin Inc., Milwaukee, WI
Learning Bridges Research Organization Inc., Clayton, MO
Lewis University Project Upward, Romeoville, IL
Lukas Foss Cultural Centre Inc., Milwaukee, WI
M-2 W-2 of Wisconsin Inc., Nashotah, WI
Main Entrance Inc., Little Falls, MN
Mankato West Booster Club, North Mankato, MN
Masterworks of Minneapolis Inc., Minneapolis, MN

Merrit Youth Hockey Association, Duluth, MN
Methodist Manor of Waukegan Inc., Waukesha, WI
Midwest Hip Hop Movement, Chicago, IL
Minnesota Big Dads, Stillwater, MN
Minnesota Charitable Accounts Inc., St. Paul, MN
Minnesota Czechoslovak Center, Minneapolis, MN
Minnesota Leadership Foundation, Minneapolis, MN
Minnesota Living Center Inc., St. Paul, MN
Minnesotans for Light Rail Transit (MNLRT), Brooklyn Park, MN
Minnesota Sharp Tailed Grouse Society Inc., Duluth, MN
Mt. Zion Child Development Center, Milwaukee, WI
Naperville Youth Football League, Naperville, IL
National Coalition of Black Amer Men Inc., Milwaukee, WI
Nels Sorensen Memorial, Minneapolis, MN
New Jerusalem Ministries Inc. Green Bay, WI
North Star Focal Point Center for Adolescents, Minneapolis, MN
Northstar Stair Community Land Trust, St. Paul, MN
Opera 101 Theatre Company, St. Paul, MN
Over and Back, Northfield, MN
Ozark Mountain Center for Environmental Education, Alton, MO
Park Rapids Activities Foundation Inc., Park Rapids, MN
Phillips Tender Loving Care, Minneapolis, MN
Prevail-Psychiatric Reform Thru Education Visionary Action, Madison, WI
Princeton Alumni Association, Inc., Princeton, MO
Project Fresh Start, Chicago, IL
Property Management Resource Center, Chicago, IL
Quality Behavioral Care, Chicago, IL
Racine County Clubhouse, Inc., Racine, WI
Remedial Education Adolescents Disadvantaged Foundation Inc., Baton Rouge, LA
River Falls Educational Foundation Inc., River Falls, WI
River Forest Boosters Association, Chicago, IL
River Valley Child Center Inc., Spring Green, WI
Running Water Historical Society, Yankton, SD
Save Our School Inc., Streator, IL
Service Personnel Support Group, Rochester, MN
Shepherds Foundation Inc., Union Grove, WI
Shoreview Historical Society, Shoreview, MN
Sian Ka An Biosphere Foundation, Minneapolis, MN
Silk for Life Project Inc., Milwaukee, WI
Sind Medical Association of North America Inc., Milwaukee, WI
Society of Noise Reductionist Inc., St. Paul, MN
South Dakota Concrete Promotion Association, Spearfish, SD
Space West Ridge Community Development Center, Chicago, IL
Therapeutic Recreators for Recovery, Algonquin, IL
United for Progress Outreach Organization, Chicago, IL
U.S.S. Springfield Commissioning Committee, Springfield, IL
Whiteside County AIDS Network, Morrison, IL
Women at the Court House, Minneapolis, MN
Womens Board, Chicago, IL
XI Lambda Educational Foundation, Chicago, IL
Youth Enjoying Sobriety, Peoria, IL

If an organization listed above submits information that warrants the renewal of its classification as a public charity or as a private operating foundation, the Internal Revenue Service will issue a ruling or determination letter with the revised classification as to foundation status. Grantors and contributors may thereafter rely upon such ruling or determination letter as provided in section 1.509(a)–7 of the Income Tax Regulations. It is not the practice of the Service to announce such revised classification of foundation status in the Internal Revenue Bulletin.

Announcement of the Disbarment, Suspension, or Consent to Voluntary Suspension of Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries From Practice Before the Internal Revenue Service

Under Section 330, Title 31 of the United States Code, the Secretary of the Treasury, after due notice and opportunity for hearing, is authorized to suspend or disbar from practice before the Internal Revenue Service any person who has violated the rules and regulations governing the recognition of attorneys, certified public accountants, enrolled agents or enrolled actuaries to practice before the Internal Revenue Service.

Attorneys, certified public accountants, enrolled agents, and enrolled actuaries are prohibited in any Internal Revenue Service matter from directly or indirectly employing, accepting assistance from, being employed by or sharing fees with, any practitioner disbarred or under suspension from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents, and enrolled actuaries to identify such disbarred or suspended practitioners, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been suspended from such practice, their designation as attorney, certified public accountant, enrolled agent, or enrolled actuary, and date of disbarment or period of suspension. This announcement will appear in the weekly Bulletin for five successive weeks or as long as it is practicable for each attorney, certified public accountant, enrolled agent, or enrolled actuary so suspended or disbarred and will be consolidated and published in the Cumulative Bulletin.

After due notice and opportunity for hearing before an administrative law judge, the following individuals have been disbarred from further practice before the Internal Revenue Service:

Name	Address	Designation	Effective Date
Noske, Joan Marie	Bismarck, ND	CPA	September 7, 1996
Dalrymple, John K.	Troy, MI	CPA	September 26, 1996

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified,* below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.

Acq.—Acquiescence.

B—Individual.

BE—Beneficiary.

BK—Bank.

B.T.A.—Board of Tax Appeals.

C.—Individual.

C.B.—Cumulative Bulletin.

CFR—Code of Federal Regulations.

CI—City.

COOP—Cooperative.

Ct.D.—Court Decision.

CY—County.

D—Decedent.

DC—Dummy Corporation.

DE—Donee.

Del. Order—Delegation Order.

DISC—Domestic International Sales Corporation.

DR—Donor.

E—Estate.

EE—Employee.

E.O.—Executive Order.

ER—Employer.

ERISA—Employee Retirement Income Security Act.

EX—Executor.

F—Fiduciary.

FC—Foreign Country.

FICA—Federal Insurance Contribution Act.

FISC—Foreign International Sales Company.

FPH—Foreign Personal Holding Company.

F.R.—Federal Register.

FUTA—Federal Unemployment Tax Act.

FX—Foreign Corporation.

G.C.M.—Chief Counsel's Memorandum.

GE—Grantee.

GP—General Partner.

GR—Grantor.

IC—Insurance Company.

I.R.B.—Internal Revenue Bulletin.

LE—Lessee.

LP—Limited Partner.

LR—Lessor.

M—Minor.

Nonacq.—Nonacquiescence.

O—Organization.

P—Parent Corporation.

PHC—Personal Holding Company.

PO—Possession of the U.S.

PR—Partner.

PRS—Partnership.

PTE—Prohibited Transaction Exemption.

Pub. L.—Public Law.

REIT—Real Estate Investment Trust.

Rev. Proc.—Revenue Procedure.

Rev. Rul.—Revenue Ruling.

S—Subsidiary.

S.P.R.—Statements of Procedural Rules.

Stat.—Statutes at Large.

T—Target Corporation.

T.C.—Tax Court.

T.D.—Treasury Decision.

TFE—Transferee.

TFR—Transferor.

T.I.R.—Technical Information Release.

TP—Taxpayer.

TR—Trust.

TT—Trustee.

U.S.C.—United States Code.

X—Corporation.

Y—Corporation.

Z—Corporation.

Numerical Finding List[1]

Bulletin 1997–1 through 1997–6

[1]A cumulative list of all Revenue Rulings, Revenue Procedures, Treasury Decisions, etc., published in Internal Revenue Bulletins 1996–27 through 1996–53 will be found in Internal Revenue Bulletin 1997–1, dated January 6, 1997.

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[1]A cumulative finding list for previously published items mentioned in Internal Revenue Bulletins 1996–27 through 1996–53 will be found in Internal Revenue Bulletin 1997–1, dated January 6, 1997.

NOTES